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(Continued inside cover)

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Volume I, No. 3 September 1948

WHY PUBLIC FINANCE?

GERHARD COLM *

An Apology

A METHODOLOGICAL article usually starts with an apology—for good reasons. In general, it is more important to contribute to the solution of a burning problem than to investigate whether there is a problem. Nevertheless the author feels intellectually disturbed by the fact that we are publishing books on public finance, conducting academic courses in public finance, devoting magazines to public finance [1]—and the present trend in economic thinking seems to suggest that there is really no longer any *raison d'etre* for such a separate field in the social sciences. Are we, in treating public finance as a separate field of study, perhaps carrying over a concept that had its justification in the past but that should be submerged in present circumstances? In this article I intend to defend public finance as a special field of study, but in my defense it may turn out that I propose some modifications in the traditional approach.

In order to make sure that we are not setting up a straw man, I shall outline briefly some of the arguments that seem to invite the conclusion that there is no longer any reason for dealing with problems of public finance as a separate field of study and training.

The Case Against Public Finance [2]

Nobody doubts the need to study tax problems or debt problems or the financial aspects of defense expenditures, public works, or any other government functions, but is there any justification for treating these problems as parts of *one* field? Tax problems are most directly related to income and price problems; government expenditures for flood control invite treatment in connection with natural resources; social security problems are

* The author is an economist on the staff of the President's Council of Economic Advisers. The views expressed are those of the author and do not necessarily reflect the official views of the Council.

[1] This *Journal* is defined by the President of the National Tax Association, George W. Mitchell, as a "medium for competent comment on important issues in public finance and taxation." Three periodicals on public finance have been established or re-established in Europe since the war, namely, *Openbare Financien*, in the Netherlands; *Revue de Science et de Législation Financières*, in France; and *Finanzarchiv*, in Germany.

[2] This discussion is limited to problems of public finance on the national level. The conventional approach is much less questioned with respect to state and local finance.

closely related to employment and wage problems. Government debt management is related to general questions of credit and banking. Government receipts and expenditures are related to the flow of national income and employment. In all fields of general economics there is plenty of opportunity to deal with various types of taxation, government expenditures, and debt problems. There is a strong case for treating the effect of government action wherever it occurs in the economy.

But what is the reason for pulling these various government actions together into one field? The traditional answer to this question is, of course, that all these fields of public finance are related to the budget; and that the budget, which represents a "national program . . . our work plan,"[3] is a unifying concept and a unifying institution in the area of public finance. That is, I believe, a valid answer, but before accepting it we must consider that this answer too has been challenged by rather forceful arguments.

The traditional reason for dealing with the budget as a unit, embracing expenditures of the government as well as revenues, was the belief that taxes have the prime purpose of providing the money needed to pay for expenditures and that in deciding on a feasible program of expenditures the availability of tax revenue should be a major consideration.

For the sovereign government with access to central bank credit, however, tax yields do not limit the amount of money the government can spend if it decides to do so. From this A. P. Lerner, for example, draws the conclusion that taxation has the sole purpose of seeing to it that the people have left in their hands just the right amount of money that enables them to buy the possible output of goods for sale.[4] As the amount of expenditures is one of the factors influencing the money people have in their hands, an increase in government expenditures *may* create a condition that requires an increase in taxes too in order to avoid inflation. But the need for an increase in taxes may also result from an increase in private business investments or net exports; or, if the increase in expenditures occurs at a time when private investments happen to decline then there is no reason for increasing taxes. Thus, according to this approach, there seems to be no more relationship between government expenditures and government taxes than there is among all other elements in the national and international economy. This reasoning may appear to lead to the logical conclusion that a budget comparing proposed expenditures and revenues no longer has any significance as a guide for policy.

The limited validity of this idea has been recognized by considering fiscal policy not merely within the frame of the government budget but within the frame of the nation's economic budget.

[3] President Roosevelt in the budget message of January 3, 1941, *U. S. Budget for the Fiscal Year 1942*, p. XIV.

[4] See, for example, *Economics of Control* (New York: Macmillan Co., 1944), chap. 24. Reference is made to Lerner because the position he takes in the chapter referred to is the most uncompromising and therefore particularly suitable for an argument about the principles. Lerner has indicated elsewhere that he recognizes that taxation has other specific purposes but can never be justified solely for the government's need for money. See also various statements by Beardsley Ruml, such as, ". . . our taxes should be as low as they possibly can be without putting the value of our money in danger of inflation." (*Proceedings of the National Tax Association*, 1944, p. 167.)

Here government expenditures as well as tax collections are viewed in their interrelationship with consumer income, expenditure, and savings; business profits and investments; and international transactions.[5] Yet we intend to argue below that this consideration of public finance within the frame of the national economy as a whole should supplement rather than supersede a consideration of government expenditure, revenue, and debt problems as a unified field of interrelated economic and social phenomena.

Historical Origin of Public Finance

Doubts as to the justification of still treating public finance as a separate field of study may be accentuated if we look at the rather strange historical origin of this science.

Public finance has two main roots. One of them lies in the cameralism of the sixteenth to eighteenth centuries. Cameralism was developed by the advisers and panegyrists of kings and princes and by the teachers of prospective public servants of these kings and princes. It embraced all economic, social, and financial facts pertinent to the management of government affairs, and practically all economic, social, and financial facts were believed pertinent to the management of government affairs. In the thinking of these writers there was no distinction between the private and public sphere of economics.

The second root of public finance lies in the writings of the classical school and their followers. They treated government activities largely as an outside, noneconomic factor modifying price and income relations in the economic system of private enterprise and exchange. The philosophers of the classical school did not deny the importance of state activities, but their scientific interests were aroused by the ideal of a self-regulatory exchange economy. While the cameralists believed in the divine origin and mission of the monarch, the classical writers were inspired by the belief in a divine power which controls the "*ordre naturel*" of the economic system just as it controls the movement of celestial bodies and the growth of vegetable and animal life.

In analyzing this self-regulatory system, the effect of taxes on income distribution and prices was treated as a disturbing factor. Thus the classical school contributed directly to the analysis of shifting and incidence of taxation. Equally important, however, was its negative contribution: the fact that classical doctrine failed to give adequate attention to government transactions forced the development of a special science of public finance.

Public finance was thus developed as a special field by writers who grew up in the conviction that the analysis of the self-regulatory economic process was the main topic of general economics but who also recognized that the economic and financial affairs of the government required a special and systematic treatment in the literature and in academic teaching. Public finance was the product of a strange marriage between cameralistic tradition and classical economics.

[5] For a survey of the use made of this approach in various countries, see Gerhard Colm, "The Government Budget and the Nation's Economic Budget," *Openbare Financien* (The Netherlands), Vol. I, 1948.

These origins are still reflected in many textbooks and curricula in public finance. The emphasis is on factual, institutional information (carried over from the cameralistic tradition) with a somewhat unrelated analytical treatment of shifting and incidence of taxation (taken over from the classical tradition). No genuine theory of the role of government within the economic process is presented because it is tacitly assumed that the only possible theory in economics is that of the self-regulatory process, which theory is treated in general economics.

It is perhaps significant that recent progress in the economics of public finance has been made largely by writers in the field of general economics rather than by specialists in public finance. The influence of Knut Wicksell, Arthur Pigou, Lord Keynes, Alvin Hansen, and Henry Simons on public finance is outstanding but they are by no means the only examples.

Today the treatment of general economic problems is no longer exclusively concentrated on the working of the self-regulatory process but gives more attention to its limitations and to the government's positive role in economics. To that extent, it appears that at least the negative reason for the development of public finance as a special science no longer exists. On the other hand, the economists treating government influences on the economy have largely neglected the essential institutional and procedural aspects of government action. That is why their analyses and recommendations are often characterized as utopian and unrealistic by the specialists in public finance. There is a wide gap between the treatment of economics of public finance and the legislative, administrative, and sociological aspects of public finance in our books as well as in actual life. Thus there still seems to be a need for study and training in public finance that gives equal emphasis to its theoretical and its institutional aspects. What, then, is this particular institutional aspect of public finance?

Organizing Principles in the Private and Public Economy

Classical thinking tended to explain all economics in terms of one set of principles such as is implied in the labor theory of value or of marginal utility. The area of public finance presented an annoying problem to the pure theorist. He regarded public finance either as a disturbing external factor of basically noneconomic origin, or he tried to explain that phenomenon away by forcing it into a general mold of value theory.[6]

Contrary to such a "monistic" explanation of the economy, I believe a more valid theory will recognize that there are several organizing principles in our economic reality. There should be distinguished the organizing principle of the family or household economy,[7] the organizing self-regulatory

[6] As one example among many, I quote the following statement by Graziani: "We know that the tax tends to take away from each and all that quantity of wealth which they would have voluntarily yielded to the state for the satisfaction of their purely collective wants." See Gerhard Colm, "Theory of Public Expenditures," *Annals of the American Academy of Political and Social Science*, January, 1936, p. 1; and Richard Musgrave, "The Voluntary Exchange Theory of Public Economy," *Quarterly Journal of Economics*, LIV (February, 1939), p. 213.

[7] The principles of the household economy which are predominant in peasant economies and have still some significance as an element even in the industrial society will not be elaborated in this article.

mechanism of supply and demand relations (in short, the market principle), and, third, the principle of the public economy (in short, the budget principle). Both the market mechanism and the budget principle are forms of organization that determine the development and use of resources (labor, material, land, technological and managerial knowledge) and the distribution of the product.

The market mechanism accomplishes the result by the interplay of millions of individuals as producers and consumers. Production is determined by profit expectations which in turn depend on demand. Demand is determined by the income derived in the process of production. The market principle is an organizing principle of such usefulness in a complex society that if we had not inherited it, its inventor today would be honored as one of the great benefactors of mankind.

Useful as it is, however, the market principle has its limitations and defects if viewed in the light of the requirements of the general welfare. It is not well applicable in some important areas of activity (e.g., road construction, multi-purpose projects of resource development); in some areas sole reliance on the market principle would be undesirable (e.g., education); in other areas its operation, under modern technological and social conditions, has undesirable consequences requiring corrective action (e.g., business fluctuations, monopolistic tendencies, property and income distribution, economic insecurity).

Therefore the market principle requires supplementary and corrective action by governments. Such actions are largely organized according to the budget principle. The essence of the budget principle is that the services in this sphere are not determined by profit expectation and by the willingness of individuals to spend their money for the purchase of such services, but by decisions reached through political and administrative procedures and based on common social objectives. The benefits from these services are not necessarily allocated to those who pay the taxes to finance them, that is, the revenues may or may not be collected from those who are the beneficiaries. The distribution of the tax burden as well as the decision as to what services should be performed and who will benefit from them is a political decision.[8]

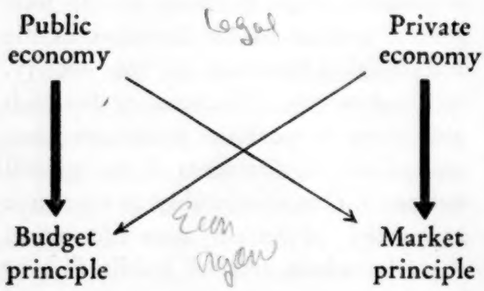
An appraisal of the performance and results of market operations, and of the character and need of supplementary and corrective government programs, is possible only if there are at least general notions of the broad economic and social objectives of the society. In other words, it is necessary for each generation to work out a concrete concept of the requirements of the general welfare. This relationship to economic and social objectives does not mean that the whole area of public finance is "controversial." As a matter of fact, most of these objectives are taken for granted at any period of time; only a relatively small, though important, fringe is controversial.

The interplay between the economic processes determined by the market principle and those determined by the budget principle is one of the main

[8] The meaning of the term "political" in this context is the same as in "political science" and is only indirectly related to "politics." See also footnote 13, below.

subjects that requires study. Any attempt to analyze government transactions as if they were determined in the same way as private transactions omits the essence of the public operations and makes it impossible to analyze the interaction of the two principles. Any useful treatment of the problems of public finance must be based on the recognition that the determination of public finance transactions is distinct from the determination of transactions of households and private business. The distinction follows from the political objectives and methods by which the government transactions are determined and executed.

At this point it may be useful to distinguish between a legal principle and an economic principle in defining these spheres in our economy, as is illustrated by the following diagram:



The difference between the public and private economy is primarily a legal distinction. The distinction between the budget principle and the market principle is a distinction between the principles of economic organization. It is true that in the public economy the budget principle is predominant; in the private economy the market principle predominates. But it is also true that we have in the public economy government-owned and operated enterprises that are guided by the market in a manner quite similar to the management of private enterprises. Then we have private educational institutions or philanthropic agencies, churches, and other private associations which follow more the budget than the market principle in their activities.

Nevertheless it can be said that the public economy, which is the subject matter of public finance, is dominated by the budget principle. Even in the case of government-owned and operated enterprises there is some public responsibility and some element of control that distinguish them from private enterprises. The political nature of government decisions does not, however, place them beyond economics. Government expenditures result in competing claims for national resources. Tax policies aid in shifting claims from private to public use. The distribution of benefits and the method of taxation affect the distribution of real income. The interplay between expenditures, revenue, and borrowing, moreover, affects the whole level of economic activity. In other words, government actions are not outside the economic field but are part of it. They affect the general level of resource use, the allocation of resources to various competing usages, and the distribution of the product. We do not have a public economy superimposed on a private economy, but we have several organizing principles which in their interplay form our economic system.

Public finance then has to do with the operations of government as they are organized under the budget principle. In this respect it is a field comparable to business management. But,

as the general economist deals with the role of business in the economy as a whole, he will also deal with the role of government. It is the proper concern of general economics, or, may we say, of the science of political economy, to deal with the way in which government operations supplement, correct, or distort activities under the market system, and particularly with the way in which the two principles may be combined and integrated to accomplish the economic objectives of the nation as a whole.

Treatment of Expenditures and Program Formulation in Public Finance

Conventional textbooks of public finance have treated expenditures mainly on a historical basis. Expanding government activities were treated as data demonstrating the growing size of the task of government financing which was regarded as the real subject matter of public finance. Some more modern textbooks show the influence of Adolph Wagner's social theory of public finance or Pigou's welfare economics. They make at least some reference to the reasons why government services, under certain circumstances, increase the "social net product" as distinguished from the "private net product," and why the public sector of the economy tends to increase in absolute and relative size. Also the debate concerning the effect of taxes on the distribution of incomes was broadened from mere analysis of the shifting and incidence of taxation to consideration of the effect of government services (e.g., education) and payments (e.g., social security and interest payments) on the distribution of money and real incomes. Under the influence of the Keynesian school, its predecessors, and successors, the effect of government expenditures, as well as of taxation and borrowing, on the level of employment has been treated in recent textbooks of public finance. As a matter of fact, it was found that even the incidence of an additional tax or a tax reduction cannot be fully analyzed without consideration of related changes in expenditures.[9] Thus there has been a growing recognition that expenditures and revenues deserve equal attention in public finance, and that the one cannot be fully treated without the other.

The treatment of expenditures has been limited, however, largely to the compilation of historical facts, discussions of social philosophy, and, most recently, to an analysis of economic effects. Very little systematic work has been done on the development of practical criteria and procedures for appraising the justification, urgency, and priority of government programs for which expenditures are contemplated.[10] Modern economics has had a very wholesome effect on recent texts

[9] For an attempted proof of this proposition, see my article "Public Revenue and Public Expenditure in National Income," in *Studies in Income and Wealth* (National Bureau of Economic Research), Vol. I, particularly pp. 185-191.

[10] A famous French engineer and economist wrote in a study on "The Measurement of the Utility of Public Works": "The legislator has prescribed formal procedures by which certain works can be declared of public utility; the science of political economy has not yet precisely defined the conditions that such works must fulfill in order to be really useful; at least the ideas that have been uttered on the subject appear vague, incomplete and often inexact." This was written in 1844. It would still be an understatement today—more than 100 years later. (Cited in "Jules Dupuit et Son Oeuvre Économique," École Nationale Des Ponts et Chaussées [Paris, 1945], p. 18.)

in public finance [11]—but in embracing the *economics* of public finance, we run into the danger of neglecting the specific problems related to policy formation, management, and operation that follow from the public character of public finance.[12]

The determination of government programs is a political procedure and, as such, is carried on in a milieu, usually called "politics," which includes vote gathering, pressure by lobbies, log-rolling, competition among political rivals, etc. The political nature of these decisions has induced many scientists to conclude that the development of any rational standards and procedures would be a hopeless undertaking.

It would be quite wrong to assume, however, that, from the standpoint of the nation's economic development, the decisions of private enterprise are wholly rational, while those of government represent a sordid compromise among self-seeking politicians. There is perhaps a presumption, but no certainty, that the investment decisions of entrepreneurs result in an expansion of the nation's productive plants which according to tempo, location, and characteristics approximates the best interests of balanced economic expansion.

Through the development of budgeting and other planning procedures, we have already gone far to ensure that these "political" decisions concerning government programs are more fully based on economic considerations. Nevertheless, continuing analysis of past errors and future objectives must contribute to further improvement of standards and procedures for the most rational determination of public programs. It must be recognized, however, that the degree to which objective criteria can be used differs greatly according to the type of program.

Programs that by their very nature are interrelated with other economic developments can be tested as to their role in a growing economy. An irrigation program, for instance, can be tested with respect to its place in a comprehensive land and water utilization program which in turn must be related to long-range national and regional objectives for agricultural output and power production, industrial developments, and other benchmarks of economic development.

The question whether an investment will "pay" for itself is of only secondary importance in the public domain. Nevertheless, there are many functions for which the benefits can be expressed in monetary terms and in which methods for cost calculations and cost comparisons can be of use. This is especially true for expenditures related to the development of natural resources, transportation, power, etc.

Many government programs are of a multi-purpose character which renders their appraisal more difficult but not impossible.

Policy is concerned not only with the formulation of meritorious programs, but also with the tempo and timing of their execution. Assume a large program, say a $5- or $10-billion program for the development of river

11 See the excellent book by Edward D. Allen and O. H. Brownlee, *Economics of Public Finance* (New York: Prentice-Hall, 1947).

12 A modern text that moves in the direction of reconciling the economic and political character of public finance is Ursula K. Hicks, *Public Finance* (Cambridge Economic Handbooks. London and Cambridge, 1947). It is perhaps not entirely by chance that this book was written by an expert in public finance who is married to an outstanding economic theorist.

basins, has been formulated and approved on its own intrinsic merits; then the tempo of execution must be decided. Will the program be planned to be completed in five, ten, or twenty years? This is the point at which program planning and budget planning converge. The decision requires at least a tentative notion of a sustainable size of the budget total and of reasonable allocations to various competing programs. Budget planning requires a movement from bottom to top, as well as from top to bottom. It starts from tentatively formulated detailed programs, sums them up, and then looks at the result as a whole. It also moves down from the formulation of a reasonable total and sets limits to detailed programs in a way that fits in with the budget target. This leads into the question of fiscal policy formulation that will be dealt with in the next section.

Expenditures which serve mainly social or political[13] purposes (in a narrower definition) are less subject to the application of rational yardsticks. The main effort with respect to these programs is to demonstrate their economic and social costs in terms of alternative use that could be made of the same resources. It must be asked whether these programs exceed the magnitude that is compatible with existing policies and with existing economic organization; the analysis of economic and social costs includes an appraisal of the measures of government controls that may be needed if very large programs are considered.[14]

Besides the development of standards for appraising expenditure programs, there is the need for devising procedures of policy formulation and policy execution. These must be political procedures, that is, they must take account of legitimate interests of the people directly and indirectly concerned, and they must establish clear political responsibility for those who participate in the decision. At the same time, procedures must be devised which assure that objective standards are brought to bear to the greatest possible extent.[15]

[13] It is annoying that the term "political" has different though related meanings. All government programs are political because they are formulated and adopted by political procedures. Political purposes, as distinct from social and economic purposes, are those which are directly related to the preservation or extension of the power of an organized nation or group of nations, such as those related to foreign policy, defense, policing, and administration of justice. This category may also include measures such as tax administration and general administrative overhead which are a means without which none of the other purposes of organized society could be fulfilled.

[14] Recent analyses of the economic impact of foreign aid and defense programs may serve as illustrations (e.g., see *The Impact of Foreign Aid upon the Domestic Economy*, October, 1947, Council of Economic Advisers, Washington, D. C.). Such analyses are not intended to suggest conclusions whether and to what extent these programs are desirable or necessary. They are intended, however, to give the legislators and the public an objective appraisal of economic and social costs, which are an important factor in the formulation of these programs. By such objective analysis the area of political controversy can be limited.

[15] For the role that budget processes may play in the development of a more rational government program formulation, see Harold D. Smith's book, *The Management of Your Government* (New York: McGraw-Hill Book Co., 1945).

The program review and program recommendations required under the Employment Act may also make for progress in the same direction. Particularly encouraging in this respect is the establishment of the Joint Committee on the Economic Report. This committee, that has to deal with the broad national aspects of economically significant programs, may, by its emphasis on national needs, present a wholesome counterweight to the narrower and sometime provincial or sectional aspects that may prevail in special committees.

Not only are procedures to guide the formation of policy required, but also methods for checking on its execution. To serve the interests of the administration, the legislature, and the people progress reports, auditing reports, and other methods of program control and supervision are essential.

In the private market economy, profit expectation of business and buyers' demand provide guidance in the allocation of resources for productive undertakings. Actual profit accounts are regarded as proof of success or failure in business planning and business operations. A considerable portion of the nation's business, however, depends on public action that is determined by political processes and not by profit expectation. When the public section was small and the main dynamic forces were carried forward by private business, it was not too costly even if " politics " was permitted to shape the actions in the public sector to a large extent. Under present circumstances, such a course would be fatal.

Though there does not exist a " scientific " determination of political decisions, scientific appraisals can and must play a decisive role in policy formulation. For this task, appropriate yardsticks and procedures must still be developed or improved. The same applies, of course, to problems of taxation and debt management.

In spite of this emphasis on economic considerations, other aspects should not be neglected. Particularly in programs that imply the use of compulsion, such as tax legislation or measures of regulation and control, public acceptability and fairness are standards at least equal to criteria of a purely economic nature.

Rules of Public Finance

The unity in government operations, discussed thus far, is of an institutional and procedural character. As government expenditures, revenues, and debt management are determined by political decisions, similar problems as to criteria of rational action and appropriate administrative and legislative procedures must be solved with respect to all of them. What about substantive unity, the interrelationship between government expenditure, revenue, and debt policy?

The era of a laissez-faire ideology developed a rather simple set of rules with respect to the interrelationship of expenditure and revenue policies of the government: (1) the lowest level is the best level of expenditures (the " necessary evil " dogma); (2) revenues should *always* equal expenditures (the " balanced budget " dogma); (3) taxes should be levied in a manner that affects existing economic relations as little as possible (the " economic neutrality " dogma).

These rules have been questioned by unorthodox writers since they were first developed, and they have been more honored in the breach than in the observance. Nevertheless, they were widely regarded as yardsticks for appraising public finance policies. Today the validity of these rules is questioned by most economists, and many doubt that any rules can be developed in place of those that have been discarded.

Are there any such rules other than those that say expenditure policies as well as revenue policies and debt management should be conducted in accord with economic requirements? In that case it would be true that expenditure and revenue policies are each

related to economic facts, but there would be no particular relationship among the elements conventionally included in public finance.

Nevertheless, serious attempts have been made in recent years to develop new guideposts for a public finance policy that could take the place of the discarded dogmas. These new guideposts, however, are not proposed as rigid rules but rather as working hypotheses.[16]

There can be only working hypotheses as a basis of public finance rather than iron-clad dogmas because public finance has to do with means or tools for attaining objectives that lie outside its own field. One may be dogmatic about an objective but the suitability of a means is judged on the ground of expediency. Public finance serves the government in fulfilling its various obligations of international and domestic policy, including particularly the promotion of balanced economic expansion. While one might say that the various aspects of business administration serve the profitability of the enterprise,[17] there is no comparable objective such as "prosperous" public finance. Thus there can be no strictly endogenous rules of public finance. The question is rather whether, assuming given objectives, it is possible to develop certain working hypotheses or rules of thumb for public finance that will be most conducive to attaining the objective.

Policy objectives and economic assumptions give a working hypothesis for appraising and formulating public finance programs. The study of the Committee for Economic Development, referred to above, proposes that long-range budget planning should aim at a moderate budget cash surplus under conditions of full employment. This implies that under conditions of sustained full employment long-run business investments will tend to exceed the sum total of business saving plus consumer net saving.

One may quarrel with this particular working hypothesis. Some people may believe, for instance, that after the end of the restocking and reconstruction boom business intentions to invest, even if encouraged by appropriate tax revisions and other policies, may somewhat lag behind the amounts business and individuals may wish to save under conditions of a sustained high level of production and income. Under that assumption, one may reach the conclusion that the government as well as business should finance some of its regular expansion by security issues rather than out of current revenues. For some countries, a continued budget surplus larger than that proposed in the CED study may be required in order to limit consumption and to facilitate the financing of continued large private capital outlays.

[16] An interesting and encouraging recent contribution in this respect is the publication of the Committee for Economic Development entitled *Taxes and the Budget: A Program for Prosperity in a Free Economy* (New York, November, 1947).

[17] Speaking of profitability as a unifying standard of the various aspects of business management is, of course, an over-simplification. Business has learned that its profitability largely depends on general economic conditions, and that general economic conditions cannot be regarded only as a datum beyond its control. In an economy of partly "administered prices" and "administered investments," business management has to take into account the effects of its action on general economic conditions as well as its direct effect on profits. To that extent, business management too transcends its conventional limits and becomes interrelated with economic policy.

The CED working hypothesis concerning the desirable moderate budget surplus does not mean that there must be a budget surplus each year, or that there must necessarily be a budget surplus even over the period of a business cycle. In the short run, government expenditures and revenue are among the tools of the government for counteracting the business cycle. The CED program rests mainly on the automatic anti-cyclical effect of government expenditures and revenue. It relies on budget fluctuations which occur even without changes in government programs or in tax laws. As soon as a downswing develops, certain government expenditures, such as disbursements for unemployment insurance or farm price support payments, increase automatically, while revenue, particularly from progressive income taxes, promptly begins to drop. Thus the budget surplus will be replaced first by a balanced budget and then by a deficit in case of growing unemployment. This deficit then will act as one of the reflationary forces helping to restore a high level of economic activity.

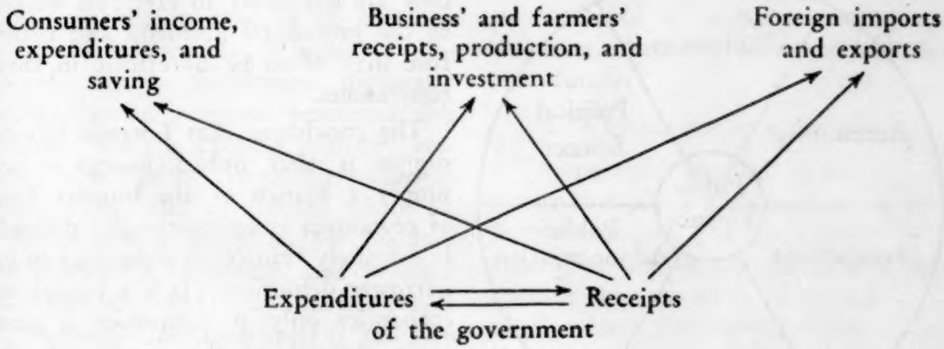
In case of a severe depression or any other emergency, the CED program would, however, not rely exclusively on this "built-in flexibility." In case of a severe depression, emergency action, particularly a reduction in taxes, would be needed. A temporary increase in taxes would be called for in case of an extraordinary inflationary boom. The CED recognizes that fiscal measures are only one among several necessary devices designed to aid in ironing out business fluctuations.

This CED proposal is a very important step toward replacing the traditional dogmas of public finance by an approach that offers a rule of thumb for long-range budget planning as well as short-run budget adjustments. In detail it is not likely to be the last word. We cannot be sure, for instance, that the variation in expenditures and receipts that results from the built-in flexibility of the budget will suffice to counteract even "normal" fluctuations in private business investments and consumer expenditures. It may be doubted that keeping expenditure programs the same irrespective of the cycle is correct policy from the aspect of a rational allocation of resources. Even besides the purposes of counter-cyclical policy, it is obvious that the relative usefulness of a government program increases when it can be undertaken without bidding resources away from private use. It is a prescription not only of a counter-cyclical policy but also of merely good management that deferrable government programs should be postponed when labor and material are scarce and relatively expensive, and that government programs should be speeded up when labor and materials are idle and less expensive.[18]

Whatever finally emerges from the present groping for a reformulation of the rules of public finance, it is clear that programs of expenditure and revenue must each be planned with respect to their economic effect. But it is equally necessary to take the quantitative and qualitative interrelationship between expenditure and revenue programs into account. The schematic figure on page 205 may illustrate the point.

[18] This argument particularly applies to Milton Friedman's reasoning in his article entitled "A Monetary and Fiscal Framework for Economic Stability," *American Economic Review*, XXXVIII (June, 1948), p. 248.

While it is true that government expenditures and revenues must be planned in relation to the nation's economic budget, it also is true that the government budget is a significant component in the nation's economic largely economic in nature, and all public finance transactions take place in the medium of economics and have economic repercussions. Public finance essentially is the science that tries to equate a political and economic balance.



budget. And it is with this component that public finance is concerned.

Public Finance a Borderline Science

Public finance deals with the manner in which government objectives are pursued through the means of government expenditures, revenues, debt management, and related transactions. Specifically, it deals with the way in which decisions are reached in the public sector of the economy and how they are executed and controlled. It cuts across the borders of a number of traditional sciences.

As we have seen in the preceding sections, decisions in public finance are reached through political procedures and determined by the interplay of the political and social forces in the society. Thus its analyses fall into the field of political science and sociology. On the other hand, the objectives are

The fact that public finance necessarily encroaches on so many fields may lead to the danger of dilettantism. This danger seems to be invited by the fact that in public finance we are compelled to cover aspects of political science, public administration, sociology, management and planning, accounting, and economics between the covers of one book or within one academic course.

Nevertheless the fact that an analysis of psychosomatic problems requires a knowledge of psychology as well as of physiology is no reason against an analysis of these borderline problems. The character of borderline problems makes them perhaps more difficult for our conventional approaches, but makes them no less urgent. Furthermore, a field that happens to be located on the borderline of several sciences need not cover more territory of knowledge than one that falls entirely within one of the conventional subdivisions of knowl-

edge. The accompanying figure illustrates this point in a schematic fashion.[19]

Our scientific approach to problems must be guided by the nature of the problem. It is the nature of public finance that it is *political* economics;

it requires a consideration of political procedures and of the forces that determine political processes, administrative procedures, and accounting procedures peculiar to this area as well as economic problems.

It follows from the borderline character of public finance that an adequate treatment of economics has to deal too with the effects of government expenditures, taxes, and debts. It also follows that the science of management cannot exclude problems of government and financial management, but none of these specialized treatments in economics, management, and so on can do justice to the problems of public finance in their entirety and interrelationship.

Economists have, as mentioned before, made considerable contributions to the development of public finance, but it is also true that economists dealing with the public sector of the economy are not likely to give full weight to the procedural problems and therefore may often be unrealistic in their conclusions.

The conclusion that I would like to suggest is that public finance is not simply a branch of the broader field of economics as conventionally defined. It definitely transcends economics in its narrower definition. It is a branch of economics only if economics is once again defined as the science of the *political economy.* This involves more than a reshuffling of labels—it involves a modified approach. We need a consideration of the problems of public finance in the context of general economics, political science, public administration, etc., and, in addition, a pulling together of these various pieces into a whole and systematic treatment of the government's expenditure, revenue, and debt transactions, their procedure and management, their integration into the whole of the political, social, and economic life of a nation. This is a necessary major field of training for government service, but also highly useful as at least a secondary field of training for general economists and business managers who need some knowledge of the nature and processes of public finance.

[19] The fact that public finance appears in the center of the figure is due less to egocentric thinking in public finance than to the exigencies of a two-dimensional presentation.

TAXATION FOR HIGHWAYS IN CALIFORNIA

RICHARD M. ZETTEL *

THE CALIFORNIA legislature in 1947 enacted a program which increased highway-user taxes approximately 64 per cent. At the same time, other significant changes in highway policy were made. Widespread demands for an accelerated highway [1] modernization program prompted this action. Of the existing highway system, it was said: "It produces congestion, waste, and annoyance where an efficient system would supply freedom of movement, economy, and personal convenience. It kills and maims people at seemingly insatiable rates in the face of a demonstrated fact that engineering and enforcement can rid highway use of its major hazards." [2]

That this condition is not unique to California is indicated in the President's Economic Report of January, 1948, which states that within ten years, 45 per cent of the nation's existing highways will have to be rebuilt.[3] This pressing need for expansion and modernization of highway facilities poses serious financial problems. Increases in special motor vehicle taxes were made in a number of states in 1947, and action in others may be expected in the near future.

1. NATURE OF THE PROBLEM

The particularly vital importance of motor vehicle transportation to the State's economy perhaps explains why California was among the first to take positive steps to solve its critical highway problem following the war. California's area is second only to Texas. It has an extensive system of State highways, county roads, and city streets, totaling about 118,000 miles. It leads the nation in motor vehicle registrations and especially in registration and use of heavy commercial vehicles of all types. About two-thirds of the intrastate freight dollar is earned by the for-hire trucking industry in California, to say nothing of the huge volume of shipments in private truck fleets. Both intercity and intracity bus transportation are important. Many vital economic areas of the State are served only by motor vehicle transportation.

Finally, California's excessive highway accident toll, far greater than that in any other state, has been a matter of considerable concern. As Governor Warren pointed out, more people were being killed on California's highways

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[1] The term highways generally includes roads and streets in this article.

[2] Joint Fact-Finding Committee on Highways, Streets and Bridges, *Preliminary Report to the California Legislature*, p. 19 (published in Journals of the Senate and Assembly, Fifty-seventh [First Extraordinary] Session, Senate Journal, January 13, 1947, pp. 7-21).

[3] *The Economic Report of the President to the Congress*, January 8, 1948 (New York: Reynal and Hitchcock, Inc., 1948), Part I, p. 63.

each year than in New York and Pennsylvania combined, despite the fact that the aggregate population of those two states was almost three times as great as California's.[4]

In 1945, before the termination of World War II, the California legislature created its Joint Fact-Finding Committee on Highways, Streets and Bridges to study all aspects of the highway problem and to make suitable recommendations for its solution.

It may be well to examine briefly the origin of the critical problem existing in California which prompted the creation of this special committee and the subsequent legislative action.

During the 1930's, the California highway construction program rapidly fell behind the requirements of an almost constantly increasing volume of highway traffic. Particularly was this true in regard to the State highway system, for in 1933 the legislature doubled the mileage in the State system by adding county roads, but did not provide additional revenues. Also in 1933, and again in 1935, the legislature increased State participation in financing city street construction without providing additional revenues. During the war years, of course, it was not possible to continue a normal highway improvement program, or even to provide adequate maintenance, with the result that an already deficient plant was considerably worse at the war's end. Moreover, traffic, which had increased 61 per cent between 1934 and 1941, was again 20 per cent higher in 1946 than in the previous high year, 1941. Traffic in 1947 was even greater and further growth is indicated for 1948.

After extensive field investigations, public hearings, and evaluation of its staff reports,[5] the joint interim committee reached four basic and controlling conclusions:[6]

1. Important segments of California's road and street system were critically deficient and needed immediate improvement.
2. The existing system of dividing road and street costs among taxpayers was inequitable in important respects and required adjustments.
3. Revisions of a fundamental nature were required in the methods employed to divide authority and responsibility among levels of government.
4. Current regulation of highway use neither produced maximum service, nor afforded adequate protection for life and property.

In this article, it is proposed to deal primarily with the second finding. It should be mentioned, however, that the committee recommended certain organizational changes, designed particularly to improve county road administration; revision of highway budget-

[4] *Highway Message of Governor Earl Warren to the Senate and Assembly in Joint Special Session* (published in Journals of the Senate and Assembly, Fifty-seventh [First Extraordinary] Session, Senate Journal, January 13, 1947, pp. 27-30).

[5] The published staff reports were three: G. Donald Kennedy, *Engineering Facts and a Future Program;* Bertram H. Lindman, *A Proposed System of Highway Financing for the State of California;* and Richard M. Zettel, *An Analysis of Taxation for Highway Purposes in California.*

In addition, a series of major addresses by Senator Randolph Collier, Committee Chairman, was published by the California State Senate under the title, "The Legislature Takes a Look at California Highway Needs."

[6] See *Preliminary Report, op. cit.* A minority report questioned cost and revenue estimates and suggested that the over-all program could be carried forward through a transitional period without immediate tax increases.

ing and financial reporting procedures; strengthening of regulation and enforcement activities; and new classifications of State highway, county road, and city street systems—all with a view towards securing more orderly and efficient development of an integrated highway plant.

The committee concluded that a vastly expanded highway modernization program with aggregate minimum expenditures approaching $3 billion before 1960 was necessary to provide a road plant adequate to produce the kind and quality of automotive service required for a balanced development of the social and economic life of California. It was manifest that the existing revenue system could not reasonably be expected to finance a program of that magnitude.

It was almost equally apparent that the existing highway tax system could be adjusted to make it more equitable; in fact, it was suggested that such adjustments were desirable even if total revenues were not to be increased.

2. MAJOR ASPECTS OF HIGHWAY FINANCE

In attempting to devise an equitable tax system, the student of highway finance is faced with perplexing problems, both theoretical and practical in nature, many of which defy measurement and analysis. He also finds wide gaps in present information and knowledge which preclude positive settlement of certain controversial issues.

Development of Benefit Principle in Highway Taxation

It would be possible, of course, to consider the provision of highways as an ordinary function of government which should be supported by general taxes levied under existing institutions. Indeed, prior to the widespread use of motor vehicles, highway provision was usually considered in this light.[7] Such an interpretation logically leads to adoption of criteria of equity in highway taxation similar to those prevailing for evaluation of the general tax system. Tested under the traditional concept of ability to pay, for example, highway-user taxes such as the gasoline tax, now generally accorded popular acceptance as fair when specifically levied for highway support, would be regarded as inequitable on grounds of obvious regressivity.

Since the early 'twenties, however, the idea that highway taxation should be related to benefits derived from highways has gained wide approval.[8] This development is quite the opposite of the common tendency in other tax fields where concepts of ability to pay have generally attained popular ascendancy, while the benefit principle is rejected because it violates a particular socio-economic concept of tax equity or because governmental benefits cannot be satisfactorily measured.

The fact that highways furnish a publicly-owned element of transportation service which competes under certain conditions with other transporta-

[7] Earlier limited use of the benefit concept in highway finance is found in toll systems on some major routes and in special assessments for certain local roads. In the main, however, road finance was regarded as a general tax problem in the late nineteenth and early twentieth centuries.

[8] Sometimes the benefit concept is interpreted to mean that highway users should defray the special "burden on the community" involved in the provision of road facilities adequate for motor vehicle traffic. Other beneficiaries are expected to defray their share of the cost under prevailing systems of general and special taxation.

tion agencies that are privately owned undoubtedly has given impetus to the benefit principle in highway taxation. Involved here are the whole issue of subsidies or public aids, the question of tax neutrality, and the proper allocation of economic resources in a complex transportation system.

The benefit principle has led to the widespread adoption of the group of special motor vehicle taxes, commonly called highway-user taxes. This development, however, has by no means eliminated basic theoretical and practical problems of tax equity in the application of highway taxes. If anything, the difficulties have been aggravated.

The Joint-Use Problem

Fundamental problems are inherent in the fact that:

> The modern road plant is a multiple-purpose facility, producing services that are distributed unevenly throughout society. All classes of roads serve in one degree or another to give access to land and dwellings; to facilitate the movement of goods and people primarily associated with community life; to supply the avenues of optimum inter-community mobility; and, finally, to expedite the administration of various essential functions of government. Thus it follows that individuals and groups of society benefit in widely varying degrees from the values produced by the several parts of the road plant.[9]

This joint-use situation gives rise to numerous conflicts of interest and results in divergent viewpoints and approaches in highway affairs. Thus, highway engineers are primarily interested in building the major routes that the motoring public demands. Who pays the cost is of little moment to them, although, in agreement with highway users, they decry diversion of user taxes to non-highway functions, and, at the state level, look with distrust upon grants to local governments because such actions diminish their resources.

Transportation economists, on the other hand, sometimes emphasize competitive aspects of highway development and its effect upon the allocation of transportation resources, with little regard for the insistent demands of motorists for a safe, convenient, and economical system of highways. They fail to recognize that the influence of highway development upon the competitive situation within the transportation industry is essentially a by-product rather than an end-product. Thus, they may seek to eliminate the economies of joint use by imposing equalizing or compensating tax burdens particularly in those areas where competition seems more or less acute.

The writer believes that highway provision must be regarded as a fundamental obligation of government, and that the economies of joint use should not be nullified by extension of user taxes for equalization or compensation purposes. However, highway users should be required to defray a substantial portion of the burden as measured by a logical allocation of highway costs or expenditures. Justification of a considerable share of highway expenditures, which loom so large in state and local budgets, may be found in the willingness of highway users to assume the cost through benefit taxation. It is not relevant to weigh against highway expenditures the merits of possible out-

[9] Charles L. Dearing, *American Highway Policy* (Washington: The Brookings Institution, 1941), p. 207.

lays for other socially or economically desirable purposes, such as schools or housing, inasmuch as special highway-user taxes could not equitably be diverted to these other purposes.

Joint use implies joint responsibility and creates two major problems of cost allocation. First, it is necessary to divide highway costs between general taxpayers, including certain special beneficiaries, and highway users. Second, it is necessary to allocate the assigned costs in some reasonable fashion among the various beneficiaries in these two groups.

Allocation of Responsibility Between Users and Others

With respect to the first proposition, few thoughtful persons argue that highway users as such should bear the entire cost of road and street provision.

It may be pointed out that roads provide access to homes and farms, furnish easements of light and air, and generally enhance property values; that they facilitate the administration of government; that they are vital to the national defense; that they furnish useful services in connection with educational, religious, recreational, and community activities, and thus weave together the social fabric.

It may also be observed that roads historically have been a function of government since ancient times; that the provision of roads has been regarded as essential to the social and economic development of this nation since its beginning; and that prior to the development of motor vehicles, road provision was generally regarded as a cost of government to be defrayed under existing tax institutions.

It may be shown that if we were to break down the road system into segments, we would find that many of the roads could not possibly earn enough in highway-user taxes to defray their cost under any reasonable schedule of user charges. Yet, government has been obliged to provide such roads for a variety of reasons.

All of these factors make it manifestly inappropriate to charge the whole cost to highway users.

In view of these circumstances, students ordinarily classify major road systems and divide portions of the cost of each class between highway users and other beneficiaries, but this assignment must be based almost entirely upon qualitative evaluation of empirical and historical factors rather than precise statistical determinations.

Annual Expenditures vs. Annual Costs.—Before the allocation of financial responsibility is examined, the annual burden to be divided should be considered. In essence, the question at issue is whether annual costs or annual expenditures are to be used. The objective of the study is ordinarily the determining factor. In California, a reasonable distribution of the necessary future tax burden was the first consideration of the legislature, once it had decided that highway modernization was desirable and that existing revenues were inadequate. Application of a corrective for past inequities was given little consideration. The effect of the tax burden assignment upon the competitive situation within the transportation industry was likewise a secondary matter.

Determination of annual costs requires the amortization of the highway investment over the life of the facilities with an appropriate assignment to future beneficiaries. Essentially, highways are regarded as a public utility and

full economic costs, including depreciation, interest, and taxes, real or imputed, are reduced to an annual charge. The computations are extremely involved, because depreciated prudent investment in highways is difficult to ascertain and especially because highway development is so dynamic.

In considering a future highway program, if it could be ascertained that an adequate highway plant could be built in say ten years, but would last for forty years, it would seem patently unfair to assess the entire cost to the users and other beneficiaries during the next decade. Rather, costs should be spread over the full life of the facilities. It should be remembered, however, that present users and others currently benefit from past expenditures.

The committee's engineering studies gave no indication that a highway construction program, fully expanded within practicable limits, would provide a completed highway *system* within a definite foreseeable time. Rather, in view of anticipated continued growth of population and motor vehicle traffic in California, it appeared that a continuous program, perhaps even larger in the second ten years than in the first, might be necessary to keep pace with the State's requirements.

For this reason, the committee was not favorably disposed toward bond financing. Contributing to the lack of enthusiasm was the unfavorable experience with bond issues for highway construction prior to 1920, which will not be fully retired until 1966, although the highways have long since been reconstructed or have become completely inadequate. Also militating against bond financing were constitutional difficulties, for one provision requires that bond issues beyond a nominal amount be approved by the electorate, while another prevents the expenditure of motor-fuel and other major highway-user taxes for debt service.

Under such circumstances, it would have served little practical purpose to determine annual costs even if the exceedingly hazardous estimates would have been generally accepted. Since annual costs probably would have been considerably less than the annual expenditures required to carry out the construction program believed necessary by the committee, such determinations would have been largely academic. The recommended program could not have been financed if the highway revenue system were geared to estimated annual costs without resorting to credit financing.

In application, of course, the pay-as-you-go method effectively limits the magnitude of any proposed expenditure program because taxes will not be increased beyond the legislative consensus regarding reasonable levels. Thus, the immediate problem before the committee was to formulate a revenue system which would permit annual highway expenditures at an accelerated rate in order to improve the road plant to desirable engineering standards within a reasonable time. In effect, then, it was necessary to assign the burden of annual expenditures rather than annual costs.

When the committee adopted the annual expenditure basis, it forestalled serious consideration of the imputed costs that are sometimes assessed against highway beneficiaries. Space limitations preclude full exploration of the highly controversial issues as to whether interest and property tax equivalents on the investment should be included in

the highway costs assignable to beneficiaries. However, the writer has serious theoretical reservations regarding the extension of the " opportunity cost " doctrine to the assessment of interest costs other than those actually paid on bonded indebtedness incurred for highway purposes.[10] If general taxpayers and highway users have each borne their proper share of highway expenditures, each has made an appropriate investment of equity capital. Under such circumstances, it seems unnecessary to set up interest charges on the investment, since, in all fairness, the interest should be returned to the beneficiaries or their successors as dividends, or reinvested in highways for their mutual advantage.

If, however, general taxpayers have supplied a greater share of the investment than required of them under a proper benefit assignment it seems plausible to charge interest to the highway users for use of the excess capital contributed by the general taxpayer. Nevertheless, it is difficult fully to justify the use of a corrective to recapture from present and future users interest costs which are assignable only because past users failed to meet their proper share of highway expenditures. Imposing an interest charge on the existing highway investment cannot correct uneconomic allocation of transportation resources since the capital is already sunk. In fact, if imputed interest were collected from users, uneconomic investment might be encouraged, for this " cost " would also be a revenue which would likely be invested in highways. Moreover, the fact that the excess contribution by general taxpayers may have come from redundant or tax-enforced savings seriously limits the validity of a " phantom " interest charge in the writer's opinion.

It is believed that a somewhat stronger case can be made for the inclusion of a property tax equivalent in the computation of highway costs assignable to beneficiaries.[11] Even though the highway user has contributed his proper share of the highway investment, and might be absolved from unpaid interest charges, he may still be charged a property tax equivalent. Presumably investment in highways is an alternative to investment in other taxable property, although the possibility of redundant and tax-enforced savings again limits the thesis. The case for tax equivalents on land purchased for highway purposes is particularly strong. And, if it can be assumed that the growth of taxable property is retarded because of highway investment, the tax exemption accorded such publicly-owned property increases the burden on the remaining taxable property for well-known reasons.[12] General taxpayers are entitled to recover a tax equivalent on the users' share of the highway investment, or, alternatively, an appropriate reduction

[10] The case for the interest charge in an analysis of the subsidy problem is forcefully stated by Burton N. Behling in his staff report for the Board of Investigation and Research (Transportation Act of 1940), ***Public Aids to Domestic Transportation***, House Doc. 159, 79th Congress, 1st Session, pp. 225-230.

[11] Ronald B. Welch lucidly explains reasons supporting the property tax-equivalent charge in Board of Investigation and Research (Transportation Act of 1940), *Carrier Taxation*, House Doc. 160, 79th Congress, 1st Session, pp. 184-186.

[12] The additional fact that competing transportation agencies are required to pay taxes on privately-owned roadways adds force to the argument for the tax equivalent charge.

may be made in the assignment of highway costs to general taxpayers.

The latter is perhaps better because both the division of cost and the computation of the property tax equivalent are necessarily rough approximations at best. In any event, the imposition of a property tax equivalent should reduce property tax burdens, and virtually the same result can be accomplished by an offset in the assignment of highway costs to the general taxpayer.[13]

The legislative committee itself did not deal comprehensively with these somewhat abstruse theories of cost assignment, but rather was interested in establishing a revenue system which would reasonably and equitably provide for required future expenditures. Expenditures rather than costs constituted the financial burden which was to be assigned to various highway beneficiaries. The possible overcharge to users involved in adoption of the expenditure basis was offset to some extent by the exclusion of imputed interest and property tax equivalent charges.

Principles of Allocation.—There are two basic approaches to the division of costs (or expenditures) between highway users and general taxpayers. By the *percentage* method, costs of each class of roads are divided, essentially by finding a fraction of the costs of each system which is considered the responsibility of general taxpayers because of special and common benefits derived either by property owners or by society in general from the availability of roads.[14] The balance is assigned to users.

The idea sometimes advanced that only the additional costs of each system which are incurred specifically for motor vehicle traffic should be assigned to users has little merit, for it is unfair to absolve certain beneficiaries of their proper share of costs of a " basic " highway system.

The *predominant-use* method seeks to classify the highway system in such a manner that full responsibility for given segments can be assigned to one group or the other with reasonable equity.[15] In brief, the cost of that system of highways which is specifically provided to supply optimum mobility of highway traffic is assigned to users and the costs of all other roads and streets are assigned to general taxpayers even though mixed benefits and joint responsibilities are involved. The method has practical virtue in establishing suitable lines of authority and responsibility among levels of government, but, in the writer's opinion, there are almost insurmountable obstacles to such a precise and rigid classification. Highways in the large intermediate class between land access roads and major traffic arteries cannot be clearly assigned to either group.

[13] In principle, it might be argued that a property tax equivalent should be charged to beneficiaries other than highway users and property taxpayers, in order to increase the property tax base, which seems so vital to the continued independence of local governments; but less cumbersome means of bolstering local governments' resources would be preferable.

[14] Property owners are usually called upon to bear highway costs for two reasons. Certain roads primarily render service to specific parcels of land and special assessments may properly be made. Other roads may be considered the responsibility of the community to be met through the general tax system in which property taxation plays a major role.

[15] A thorough presentation of the predominant-use principle is developed by Mr. Dearing. *Op. cit.*, pp. 154-163.

Method of Allocation Used.—In California, the committee's staff sought not only to provide a basis for allocation of costs, or rather expenditures, between general taxpayers and highway users, but to suggest how and at what level of government the general taxpayer should make his contribution. It was essential to recognize the complications attendant upon the existing division of responsibility between State and local government, particularly since sentiment for local autonomy is especially strong in California. At the same time, it was desirable to suggest an allocation of financial responsibility which would promote the most efficient expenditure of road funds.

Highway-user taxes are imposed and collected by the State, but a substantial portion of the revenue is shared with local government. If apportionments are excessive, dispersion of such revenues on road systems which are of no importance to the large majority of users is likely. Local governments might use only highway-user taxes for road purposes with the result that the general taxpayer would make no contribution at all for roads. Centralization of all road administration in the State would have aggravated this situation and would have resulted in a greater loss of local control than most thoughtful persons would advocate.

Under such circumstances, it seemed appropriate to provide for practicable State control of the expenditure of a share of user tax revenues by local governments.

These considerations made it suitable to employ an eclectic and pragmatic method of assignment. Proper classification of the road plant according to the nature and extent of use appeared to be an appropriate starting point.[16] It was thought that the full cost of State highways should be borne by the highway users. It was suggested that county road and city street systems each be divided into two major categories—primary county roads and other county roads and major city streets and other city streets. The full cost of "other" county roads and "other" city streets—primarily access roads and streets—was assigned to general taxpayers, and it was recommended that expenditure of highway-user tax revenues for their construction and maintenance be prohibited. A rough balance between the benefits rendered by State highways to beneficiaries other than users and the benefits rendered by the local road systems to highway users was assumed.[17]

Assignment of financial responsibility for primary county roads and major city streets—the community service

[16] The committee's engineering staff recommended reclassification of the State highway system and the transfer of certain mileage to county jurisdiction. The legislature refused to take any roads out of the State system and also modified other recommendations with regard to subclassifications of the major systems.

[17] No adjustment was made for the "sales tax component" in the gasoline tax. Since the State's general fund, and hence, the general taxpayer, suffers by reason of the unwarranted exemption of gasoline from the retail sales tax, it may be argued that the general taxpayer contributes to State highway support to this extent. Also debt service on outstanding State highway bonds, issued prior to 1920, is being paid from general tax proceeds although the amounts are small. It is appropriate to note that the State in performing its regular functions derives significant benefits from highways which justify charges against general taxpayers.

systems—is complicated by the insoluble admixture of services rendered. It was finally decided that highway users should bear the costs of construction and general taxpayers the costs of maintenance.

This method rather than a percentage division of responsibility was defended mainly on pragmatic grounds, for it might be argued that maintenance even more than construction costs should be borne by users. However, it was felt that the State as the collector of user taxes had the basic responsibility for their efficient expenditure and should therefore exercise some control. Such control can be exercised more effectively over the expenditure of construction funds than over maintenance expenditures. An additional advantage is found in the fact that the State, if it chooses, can prescribe standards of construction, and, by coordinating plans, can ensure the development of systems of primary county roads and major city streets properly integrated with the State highway system.

Actually, engineering estimates of needed highway expenditures indicated that the proposed assignment of the burden would require highway users to pay 76 per cent and general taxpayers 24 per cent of the taxes to be raised by the State and local governments.[18]

During the prewar fiscal years, 1937 through 1941, it was found that the contributions of highway users and general taxpayers (excluding Federal aid) were 68 per cent and 32 per cent, respectively. Thus, the proposed allocation would have shifted somewhat more of the responsibility to users than they had previously borne.[19]

Such an assignment is by no means out of line with conclusions reached in other studies. Nor did it violate to any substantial degree the subjective judgment reached by the staff based upon historical and empirical analyses.[20] At the same time, it appeared to meet the legislature's need for a sound method of apportioning highway-user taxes and insuring their most efficient expenditure.

Assignment of Users' Share of Costs

Having determined, to its own satisfaction at least, a reasonable allocation between users and others, the staff proceeded to assign the users' burden of future expenditures among various vehicle classes and to formulate a user

[18] It was estimated that if Federal highway grants-in-aid were continued at prewar levels they would supply 4 per cent of the required expenditures. Federal aid, of course, is appropriated from the general fund, but the Federal gasoline and other motor vehicle excise taxes are considered highway-user taxes in some quarters, although the matter is controversial. The issue was not considered important to the problem at hand. California's contribution in Federal gasoline taxes far exceeds the highway grants which it receives. From the State's point of view, therefore, repeal of the Federal gasoline tax would be desirable even though repeal were contingent upon discontinuance of Federal aid for highways.

[19] In this regard, however, the trend is important, for through the years increasing shares of road costs have been shifted to highway users. In 1925, user-tax expenditures in California were 32 per cent of the total; in 1930, 55 per cent; in 1935, 59 per cent; and in 1940, 69 per cent. If this trend were to continue unabated, users would soon be called upon to furnish all highway, road, and street funds.

[20] In this connection, traffic, road use, and origin and destination surveys provided useful quantitative data. Also evaluation of particular roads in terms of user-tax earnings, estimates of potential savings to motorists from high-standard road improvement, and historical analysis of the road function before and after the motor vehicle aided in formulating reasonable conclusions.

tax system which would equitably raise the required funds.[21]

Theories of Cost Assignment.—With respect to the allocation of the users' share of highway costs, an evolution of thought over the years is evidenced in the literature on the subject. In the early 'twenties when highways were lightly constructed, a "damage caused" theory was advanced. In brief, it was suggested that heavy vehicles should defray the cost of any excessive "wear and tear" of the highways resulting from their operation.

While this theory still prevails in some quarters, it has less application today because engineers now strive to construct highways which will carry mixed traffic without harm. Modern highways are not ordinarily damaged by properly regulated heavy vehicular traffic. Nonetheless, heavy vehicles not infrequently cause damage to certain flimsy county roads and city streets and even to some state highways and bridges, thereby creating a serious problem. In fact, it may well be asked whether it is economically sound to reconstruct to heavy vehicle requirements all or a substantial portion of such secondary roads.

[21] It was believed that the method of cost assignment and the suggested controls would require local governments to raise the proper general tax contribution under existing institutions, and that the staff had no responsibility for suggesting changes in the general tax system. It was recognized that it would be quite proper to impose special assessments to defray the cost of access roads and streets, especially in new areas or subdivisions. Such roads primarily benefit land owners and should be improved to acceptable standards before taken into the general system. The possibility of using general funds collected by the State to equalize the road and street maintenance costs was also suggested because of the great disparity between such costs and taxable resources in certain areas.

However, the "damage caused" theory is also defective as a basis of cost assignment in that it does not provide for allocation of ordinary construction and maintenance costs. Moreover, restriction or regulation of use rather than taxation appears to be the better remedy where highways are actually damaged by heavy vehicles.

In current thinking, two other basic approaches are found. One, the incremental cost or "cost caused" theory, has much logical appeal. It suggests that a basic highway system for passenger car traffic can be constructed at considerably less cost than would be required for heavy vehicles. For example, a certain thickness of pavement and a certain width might suffice for passenger car traffic, so the cost of any necessary additional thickness and width should be assessed to the heavy vehicles. Successive increments of cost would be developed for each class of vehicles.

At this point, the economist must turn to the highway engineer for the necessary factual information. In California, neither the committee's staff engineers nor the State Highway Division was able to supply answers upon which a satisfactory cost assignment could be based.

In fact, the writer has seen no entirely convincing data regarding correct increments of cost to be assigned to vehicles of various weight classes. For bridge construction and certain other specific highway costs fairly conclusive evidence is found, but so many questionable estimates are involved in establishing increments for costs of an entire road plant that the results can be regarded as little more than informed

guesses, subject to considerable dispute.[22]

Although the writer believes that continued study in this field is desirable, even if precise data were available, difficult theoretical problems would remain. To illustrate, allowances should be made for the greater highway occupancy of heavy vehicles, and for the interferences with the smooth flow of traffic and the additional hazards created by heavy vehicles. Also, it remains to assign those joint costs which are not a function of weight as well as the joint costs within each increment. For example, to what extent should the heavy vehicles share in the costs of a "basic" highway system? Should an assignment be made on the basis of mileage alone or should weight also be considered on the grounds that benefits are derived from the basic highway in relation to both factors?

In the absence of conclusive engineering data regarding incremental costs,[23] many students have turned to a relative-use method of assignment, whereby the entire users' share is distributed without reference to possible additional costs incurred for heavy vehicles or damage caused by such vehicles under given circumstances. Rather, an attempt is made to allocate highway costs in relation to the use which each vehicle makes of the highway.

It is argued that all highway costs are joint for all practical purposes. The basic assumptions involved are that relative use and relative benefit coincide and that the users' assigned share of highway costs is the monetary equivalent of the benefits derived.

The most satisfactory measure of use and, hence, of benefit is believed to be the gross ton-mile. Under this theory, then, a 15-ton truck would be taxed ten times as much as a 1.5-ton passenger car traveling an equal distance.

Although the gross ton-mile appears to be a plausible measure of highway benefit, it is by no means perfect. For example, the question of value of service may be raised.[24] Does the operator of a truck carrying a valuable shipment, such as fruit, derive greater benefit from highway use than an operator carrying a cheap commodity, such as gravel, an equal number of ton-miles? This is a moot question, but actually no practical method of incorporating value of service into the user tax system has been discovered.[25]

[22] With respect to the incremental cost approach, the U.S. Public Roads Administration has said: "Although the basic concept has been accepted by many students, its application involves so many compromise solutions and arbitrary decisions that the dissenter is neither persuaded nor forced to accept the conclusions of a study in which this approach is used." (Board of Investigation and Research, *Public Aids to Domestic Transportation*, p. 1015)

On the other hand, the State Highway Department and Legislative Interim Committees in Oregon have made incremental cost findings which have led to revisions of the user tax system. See, for example, Legislative Interim Committee for the Study of Motor Transportation in Oregon, *Reports*, January 1, 1945, and January 1, 1947.

[23] Dr. Behling discusses sixteen separate reasons for rejecting the incremental cost theory, before turning to the relative-use method of assignment. *Op. cit.*, pp. 296-305.

[24] *Cf.* Washington Highway Cost Commission, *Supplemental Report*, January, 1937, pp. 69-76.

[25] The U.S. Public Roads Administration rejects the idea that value of cargo and value of service, which it defines as the costs of ownership and operation of vehicles, are in any way related. (Board of Investigation and Research, *Public Aids to Domestic Transportation*, p. 1018) While cargo value and direct costs are not directly related, it is pertinent to inquire whether a proposed user tax system will be so high as to restrict transportation of low-value commodities, force out many marginal highway users, and seriously impede economic development. In the staff's judgment, the proposed ton-mile assignment of highway costs would not have involved such excessive tax burdens.

The Administration in criticizing the ton-mile method also suggests that direct costs of owning and operating equipment might be an appropriate measure of highway benefit which should be considered in fixing user taxes. (*Ibid.*) Not only is it difficult to visualize a workable user tax system geared to direct operating costs, but the theoretical superiority of an allocation of highway (overhead) costs in proportion to vehicle operating (direct) costs over an allocation based upon relative use as measured by ton-miles, which reflect both weight and distance, is not apparent to the writer.

It appeared to the committee's staff that the straight gross ton-mile assignment of costs was the only reasonably sound method that could effectively be translated into a feasible user tax system.

However, revisions in the tax structure which would preserve the existing distribution of the burden among major vehicle classes were suggested as a possible alternative to a full ton-mile assignment with the idea that such a minimum adjustment would be least disruptive to a pattern of transportation services which had produced good results over a considerable period of time. In this regard, it may be noted that California highway-user taxes on private commercial and intracity for-hire vehicles were among the lowest in the nation. Contributions by intercity for-hire vehicles, including the gross receipts tax as a highway-user payment, were more in line with national averages but were by no means excessive. Even under the alternative, however, it was recommended that the ton-mile allocation be used to distribute the burden assigned to commercial vehicles.

Definition of User Taxes.—Frequently, failure to distinguish carefully between highway-user taxes and general taxes which are paid on vehicles as an incident of the general tax system makes it appear that the motorist is over-burdened. The writer defines a highway-user tax as one paid incident to the operation of vehicles upon the public highways which has no direct or ascertainable counterpart in the general tax system. Taxes on the sale of vehicles levied under a general sales tax or on vehicles as personal property are obviously excluded. On the other hand, gasoline and registration and weight taxes are included.[26]

In some instances, the distinction is not so apparent. In California an excise tax based on the value of vehicles is levied in lieu of personal property taxes. Because the tax is collected by the State at the time of vehicle registration and has been labeled an excise rather than a property tax by the courts, it has been regarded as a highway-user tax in some quarters and use of its proceeds for non-highway purposes has been considered diversion.[27] The writer regarded the California " in lieu " tax as a general tax.[28]

[26] In principle, where gasoline is exempt from a general sales tax, a sales tax component should be deducted from the gasoline tax proceeds to determine the net user tax contribution. Likewise, if the ad valorem tax system applies to personal property generally but vehicles are exempted, it is appropriate to deduct a property tax component from registration taxes.

[27] The U.S. Public Roads Administration so treats the tax in its annual statistical tables, SF 1 and 2.

[28] See *An Analysis of Taxation for Highway Purposes in California*, pp. 54-60. Both Senate and Assembly Interim Committees reached similar conclusions with regard to the nature of this tax. Assembly Interim Committee on State and Local Taxation, *Report*, January, 1947, p. 42; Senate Interim Committee on State and Local Taxation,

On the other hand, the 3 per cent tax applicable to the gross receipts of intercity, for-hire motor carriers was regarded as a highway-user tax even though the proceeds were not used for highway purposes. There was no counterpart in the general tax system, and, incidentally, historical analysis revealed that the legislature originally imposed the tax as a compensation for highway use by selected commercial operators. However, another gross receipts tax applicable to all regulated utilities, including both railroads and motor carriers, levied for support of the regulatory commission was regarded as a general tax for obvious reasons.

Formulation of a User Tax System.—In all states, the gasoline tax is the backbone of the highway-user tax structure because it is a popular and reasonable measure of highway use, producing large returns at small cost. If all vehicles were of similar size, it would be an almost ideal user tax. Its principal defect lies in its regressivity measured in terms of the gross ton-mile.[29]

The technique adopted by the staff in formulating a user tax system was to determine the supplement to a specific gasoline tax necessary to exact equal payments per ton-mile for the typical vehicle in each size group. A gasoline tax "deficiency" was found by comparing the estimated gasoline tax contribution per ton-mile for a typical passenger car with the ton-mile contribution by the average vehicle in each of the heavier classes. For example, it was estimated that a typical truck with an average gross operating weight of 10.2 tons would incur .872 mills less in gasoline taxes per ton-mile than a typical passenger car at a 4-cent rate. When reduced to a mileage basis, the tax supplement necessary to make up the gasoline tax deficiency was 8.9 mills per mile.

The best means of making up such deficiencies in order to equalize payments per ton-mile would be a graduated mileage tax system. Therefore, proposed schedules were drawn up, but only after the State Board of Equalization expressed confidence that a mileage tax could be successfully administered.

A much less satisfactory alternative to the mileage tax would have been to impose annual weight taxes found as the products of the annual average mileage and the gasoline tax deficiency per mile for the typical vehicle in each weight group. Although each group would have met the burden assigned to it, the considerable dispersion from the annual average mileage would create serious inequities among vehicles in the group. To take one example, the annual average mileage of medium-sized trucks of 3 to 4.5 tons rated capacity in 1941 was 13,928 miles. However, only 17 per cent of the intercity for-hire trucks and 26 per cent of the private trucks were in the mileage interval, 10,000 to 14,999 miles, that

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Report, January, 1947, Part II, p. 390.

In 1947 the legislature in providing that virtually all of the tax proceeds be returned to counties and cities also recognized the basic nature of the tax. (Stats. 1947, Ch. 1168, p. 2647) In 1948 the tax rate was increased to bring it more into line with the ad valorem tax burden on other property. (Stats. 1948, Ch. 26).

[29] Differences in efficiency of various fuels also render the tax imperfect. For example, a truck using Diesel fuel can travel considerably farther per gallon than a truck of similar size using gasoline. The need for differentiated rates per gallon of fuel is indicated if equal compensation for highway use is to be exacted. See the writer's discussion of this problem in Journals of the Senate and Assembly, Fifty-seventh (First Extraordinary) Session, Assembly Journal, March 31, 1947, pp. 714-718.

included the average. Twenty-eight per cent of the intercity for-hire trucks traveled less than 10,000 miles, 26 per cent traveled 30,000 miles or more, and 10 per cent traveled 50,000 miles or more. Of the private trucks, 50 per cent traveled less than 10,000 miles, but 8 per cent traveled 30,000 miles or more. Obviously, any schedule of annual weight taxes creates substantial discrimination in terms of relative road use among vehicles in a given weight group.

A further refinement might be made by classifying vehicles according to use as well as weight and establishing different tax schedules for each of the subclassifications. By this method, weight taxes would be differentially higher for intercity, for-hire vehicles and lower for farm trucks than for ordinary private commercial and intracity vehicles. However, dispersions from average mileage within the subclassifications would still be substantial, and, hence, inequities would remain. Moreover, serious administrative difficulties would be encountered under such a scheme.

For these reasons, the staff decided that a mileage tax system, at least for large vehicles, should be recommended. The joint interim committee reached the same conclusion.

3. TAX RECOMMENDATIONS

The committee's economic staff finally recommended an increase in the gasoline tax, an increase in the Diesel fuel tax which would make the rate per gallon 50 per cent higher than on gasoline, and a new system of annual gross weight taxes on smaller commercial vehicles and mileage taxes graduated in relation to gross weight on larger vehicles. No change in the basic registration tax was recommended,[30] but the imposition of a driver's license fee to cover costs of an expanded state highway patrol was suggested. In general, the committee followed the staff's recommendations as to basic principles in its report to the legislature.

The staff recommended further that the ultimate tax system be geared to the size and timing of the construction program finally decided upon by the legislature and that the balance between the various taxes be studiously maintained. To accomplish this, any increase in the proposed gasoline tax rate to accelerate the highway modernization program would require an upward adjustment in the recommended weight and mileage taxes in the interests of equity.

4. LEGISLATIVE ACTION

During the special session of the legislature convened by Governor Warren to deal exclusively with the highway problem, little time was devoted to the niceties of theory discussed above because a fundamental conflict arose over the advisability of making any changes at all in tax rates and highway policy.

The principal argument of opponents of the committee's proposals was that an extensive highway construction program should not be undertaken at this

[30] It was recognized that there is some justification for a flat-rate registration tax as a stand-by charge on the ground that some motorists use the highways only infrequently, but are likely to contribute to peak Sunday and holiday traffic for which highways must be designed. There is no practical means of establishing a proper stand-by charge. Obviously, the "Sunday drivers" cannot be segregated for special taxation. It was believed that the tax should be kept at a low level, for a substantial increase might aggravate the discrimination against passenger car owners inherent in the fuel tax.

time because of high costs and possible competition with other construction demands, particularly housing. It was also contended that present taxes together with unexpended balances in highway funds were adequate to meet highway needs, at least until conditions were more stable.

Proponents of the expanded program, relying upon the committee's engineering report and information from State, city, and county officials, argued that California's highways and streets were so inadequate that immediate improvement was necessary in the interests of safety, economy, and convenience. It was pointed out that even the most optimistic estimate of revenues from existing user taxes showed them to be far less than indicated highway needs of State and local governments.[31]

A second bitter fight developed over a proper system of commercial vehicle taxation. The mileage tax system recommended by the committee was eventually rejected although it had passed the Senate, because of alleged administrative and compliance difficulties. Efforts were made to repeal the existing gross receipts tax on grounds of discrimination because it applied only to intercity for-hire carriers, and to rely solely upon annual weight taxes as a motor-fuel tax supplement. For-hire trucking interests proposed a single weight tax system which would apply alike to all vehicles within each size group. Private trucking interests supported a differentially higher tax on intercity for-hire commercial vehicles, fearing that an intolerable burden might be imposed on private truck owners to compensate for loss of revenue from the gross receipts tax if it were repealed.

The several differences were finally resolved in the closing days of the lengthy special session with the enactment of the Collier-Burns Highway Act of 1947.[32] Tax-wise, this act accomplished the following:

1. Increased the gasoline tax from 3 cents to 4.5 cents per gallon.
2. Increased the Diesel fuel tax from 3 cents to 4.5 cents per gallon.
3. Imposed a more rational schedule of annual weight taxes based upon unladen weight, ranging from $10 to $120 for two-axle trucks and busses and from $8 to $200 for three-axle trucks and busses and all trailers. The burden of weight taxes was increased approximately 116 per cent.
4. Continued the 3 per cent tax on gross receipts of intercity for-hire motor carriers but transferred the proceeds to the highway fund; also provided that one-third of the weight taxes paid on vehicles used in taxable operations could be taken as a credit against the gross receipts tax liability, with the result that the tax burden on private vehicles was increased substantially more than on the intercity for-hire vehicles, thus lessening the area of alleged discrimination between the two groups.
5. Increased the basic registration tax from $3 to $6 per year.
6. Imposed a driver's license fee of $2 for four years.

It has been estimated that total

31 Major differences of opinion are found throughout the Journals of the Senate and Assembly, Fifty-seventh (First Extraordinary) Session, 1947. In particular, the separate and completely variant reports of the Senate and Assembly delegations to a specially-created Joint Committee on Highway Legislation reveal the basic issues. (Senate Journal, May 29, 1947, pp. 348-350; Assembly Journal, June 2, 1947, pp. 1037-1047)

32 Stats. 1947 (First Extraordinary Session), Chap. 11, p. 3788. The bill was named for Senator Randolph Collier and Assemblyman Michael J. Burns, Chairman and Vice-Chairman, respectively, of the Joint Interim Committee.

user tax collections for the ensuing ten-year period will increase from $1,129 million to $1,852 million, an increase of about $723 million or 64 per cent.[33] Total apportionments to counties for the ten-year period will be about $451 million, up 29 per cent over apportionments which would have been made under previous law; while apportionments to cities for streets will be about $172 million, up 143 per cent.

Most of the additional grant to counties was distributed among them on a maintained mileage basis, thus primarily aiding counties with high road mileages relative to vehicle registrations. The distribution of a share of previous taxes based almost solely upon vehicle registrations was continued without substantial change. Only a small fraction of the total apportionment was restricted to expenditure for primary road construction.

The increase in apportionments to cities, an amount equal to the increase for counties, was distributed in proportion to population, with the new amounts limited to major city street construction.

After apportionments and administrative costs are paid, the balance of user tax proceeds is to go to the State highway fund. For the ensuing ten-year period, State highway revenues will be increased almost 80 per cent and will total about $1,066 million. It is estimated that about $757 million will be available for highway construction as the balance will be required for maintenance and administration.

The State Division of Highways now estimates that the cost of correcting critical deficiencies and of needed improvements on the State highway system will exceed $1.5 billion. If this estimate proves even reasonably accurate, it is plain that there is little danger of over-expansion of California's highway facilities in the near future. Moreover, if revenues surpass expectations, it will probably mean that future traffic has been under-estimated and additional highway development will be required.

In addition to the financial features, other important revisions included in the 1947 highway act were to consolidate county road administration under a qualified commissioner in each county; to require classification of county roads and city streets, subject to State approval according to standards set by the legislature; to require more adequate reporting to the State Controller of financial transactions for highway purposes by counties and cities; to require the State Highway Commission to prepare a more detailed annual budget subject to new controls and to report annually to the legislature reasons for any deviations from the preceding year's budget.

5. EVALUATION OF THE PROGRAM

On balance, it appears that substantial improvement in California's user tax system has been achieved and that significant steps toward better highway administration have been taken. Certainly, intensive opposition to any change at all retarded advances in certain directions and precluded other

[33] All estimates in this section are taken from the writer's *Financial Analysis of the Collier-Burns Highway Act of 1947* (published in Appendix to the Journal of the Senate, Volume 1, Fifty-seventh General Session). Changes in methods of apportioning highway funds to cities and counties and other features of the act are also discussed in detail in this study. See also Thomas H. Kuchel, "Highway Revenues in California," *The Tax Digest*, May, 1948, pp. 164 *et seq.*

seemingly desirable changes.[34]

The legislation was considerably less precise in the assignment of financial responsibility between highway users and others than even the rather pragmatic determinations made by the committee's staff. The extent of the general taxpayers' contribution for highways in the future will depend almost entirely upon decisions of local government officials to augment State user-tax apportionments to permit acceleration or higher standards of local road improvement.

Political expediency was largely responsible for the rather generous grants of user tax funds to counties and cities. For the same reasons, the recommended limitations on expenditure of highway-user tax funds to prevent their dissipation on roads for which general taxpayers should have sole or primary responsibility were drastically modified. The common feeling, whether correct or not, that general taxpayers, particularly property owners, were already dangerously burdened and might be required to assume heavy additional burdens to accomodate state and local institutions to the tremendous growth of population naturally contributed to the legislature's reluctance to force general increases in non-highway-user contributions for road purposes.

With regard to the user tax system itself, development of a satisfactory method of heavy vehicle taxation proved most difficult. Rejection of the mileage tax proposal made it necessary to improvise a system which would not be unreasonable even though containing apparent imperfections. The legislature generally insisted that the over-all burden on commercial vehicles be increased relatively more than on passenger cars and that no particular group of carriers should obtain reductions in existing burdens.

The resulting combination of weight and gross receipts taxes can be rationalized basically on the ground that it required each of the two major groups of commercial carriers to pay taxes more commensurate with an assignment of responsibility on a ton-mile basis than they had paid under the previous tax system. Plainly, certain for-hire vehicles use the roads no more extensively than some private vehicles and, hence, are overtaxed under the relative-use standard. As revealed by average annual mileages, however, intercity for-hire vehicles typically use the roads much more extensively than private commercial vehicles and, therefore, should pay higher user taxes. The gross receipts tax accomplishes this objective.

Moreover, the credit provision was designed to alleviate the burden increase on for-hire vehicles, particularly those which use the highways least. It has been estimated that the combined burden of the weight and gross receipts taxes results in a 102 per cent increase for private commercial vehicles, as a group, as compared with a 13 per cent increase for the intercity for-hire group.[35]

[34] See Joint Fact-Finding Committee on Highways, Streets and Bridges, *Final Report,* 1947 (published in Appendix to the Journal of the Senate, Volume 1, Fifty-seventh General Session).

[35] The weight-tax credit provision poses certain administrative problems which await solution. A simple reduction in the gross receipts tax rate, however, would have resulted in a substantially different distribution of the tax burden among the affected carriers. Senate Bill 28 (1948 regular session) which would have reduced the 3 per cent tax to 2.5 per cent and eliminated the credit provision was defeated in 1948 for this reason. *Cf.* California State Board of Equalization, *Annual Report,* 1946-47, p. 13.

The driver's license fee was justified as a fair means of supporting the highway patrol by spreading the cost over all drivers rather than over vehicle owners alone. The fee was less than that recommended by the staff, but an increase in the annual registration tax from $3 to $6 more than made up the deficiency in revenue and in effect provided a portion of the additional apportionments to local government.

The writer believes that the committee's studies and the subsequent legislative action brought about a more balanced highway revenue system. Too often the response to demands for increased highway revenues is an increase in the gasoline tax alone, with a resulting discrimination against passenger car owners.

That the new revenue program should go far in providing California with the integrated and modernized highway system generally regarded as essential for sound future economic and social development seems obvious. The accomplishment of this basic objective largely mitigates, and perhaps offsets, certain apparent defects in the revised financial structure. Although an *ideal* balance between benefits and taxes may not be realized, all highway beneficiaries may expect to benefit in a substantial degree from the program. In fact, measured in terms of long-range savings in operating and insurance costs, and in time, it is conceivable that benefits derived by all user groups will exceed the additional tax burdens.

It is unfortunately true that in the user tax field, as in many other tax fields, we can ordinarily hope to achieve only rough equity. This is not necessarily the fault of the legislature. Complete and definitive answers to many perplexing theoretical problems have not yet been supplied. Not infrequently administrative considerations limit the implementation of logical findings. Moreover, in the final analysis, the legislature must weigh political and social implications as well as the economic factors. Under these conditions, judgment influenced by experience and bias, rather than objective facts, must play a leading role in the final determinations.

Nevertheless, it has been demonstrated in California that improvement in the user tax system can be achieved through thoughtful consideration of pertinent information. In the highway studies now underway and those which will be undertaken in the future in other states, it is to be hoped that economic and tax data as well as engineering information will be developed. A reasonable and just distribution of the highway tax burden between and among users and general taxpayers should be a primary objective.

Moreover, the effective application of sound user tax principles, within practicable limits, is essential to the preservation of a rational transportation system for the nation. The writer believes it inappropriate to employ taxation to nullify economies of joint use, but if benefit taxation for highways is not wisely applied, it will become increasingly difficult to maintain our mixed system of public and private enterprise in transportation.

Continuing study of the economic issues, as well as the engineering problems, in connection with highway modernization programs, is essential to the sound legislative action frequently needed to improve our tax structures and strengthen our entire transportation system.

AN ECONOMIC ANALYSIS OF THE CAPITAL GAINS TAX

HAROLD M. SOMERS *

THERE are a few points in our tax system with respect to which emotion seems to dominate reason and extreme statements are preferred to considered judgments. The capital gains tax is one of these. To many it seems to strike at the very roots of a free enterprise system. An example of this view is given in the following newspaper account of a statement made eight years ago by a generally sound and respected statesman and banker:

> Repeal or drastic reduction of the capital gains tax was urged today by General Charles G. Dawes, chairman of the City National Bank of Chicago, as the first step in unshackling private business and in building up national income to sustain vast expenditures for national defense.
>
> The national income cannot be increased from its present $70,000,000,000 a year to a desired $100,000,000,000, the former Vice President of the United States declared, so long as this tax devastates business, throttles recovery and retards employment.[1]

Since then we have had the Revenue Act of 1942 which made some important revisions and improved the treatment of corporations as compared with individuals.[2] There is some possibility of giving the capital gains tax a prominent place in the tax system. Serious consideration has recently been given a proposal made by Henry Simons in 1937 for the use of a thoroughgoing capital gains tax as a substitute for the taxation of corporate income.[3]

This paper attempts to evaluate the capital gains tax in economic terms. Two questions are asked: (1) Does the tax accentuate fluctuations in asset prices and promote economic instability? (2) Does the tax discourage venture capital and retard economic growth? The verdict on the first question is substantially unfavorable and on the second moderately unfavorable to the tax. The effects indicated by the analysis are serious but not by any means "devastating."

EFFECTS ON ECONOMIC STABILITY

Assume that, in the absence of a capital gains tax, there will be a certain demand and supply of a given security or piece of property. These are *DD* and SS of Figure 1. An amount *OM* of the assets will be sold at a price *OP*. What effect will a capital gains tax have on this result? If all sellers were selling at a profit subject to the capital gains tax the supply curve would shift to the position S′S′. The vertical distance between S′S′ and SS at any point

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[1] *New York Times*, November 15, 1940, p. 45.

[2] For a handy comparison see the section on "Corporate Capital Gains and Losses" in Arthur H. Kent, "The Legal Machinery of the Present Corporate Income Tax System," *Proceedings of the National Tax Association*, 1947, pp. 73-74.

[3] See the evaluation of this proposal in Richard B. Goode, *The Postwar Corporation Tax Structure* (Washington: Treasury Department, Division of Tax Research, 1946), pp. 23-27; and Harold M. Groves, *Postwar Taxation and Economic Progress* (New York: McGraw-Hill, 1946), pp. 59-62.

represents the amount of capital gains tax that would have to be paid if the security or property is sold at the price indicated on S'S'.

Not all sellers are selling at a profit, however. Some may be selling at a loss, and some may be selling at their original purchase price. In case of a loss there may be a tax saving involved to the extent that the loss is deductible. For those whose sales are at original purchase price and thus are not subject to the capital gains tax (and do not result in any tax saving) the supply curve will not shift at all from the position SS. Since the sellers are made up of all sorts, any shift of the SS curve will in practice depend on the volume of prospective sales involving tax liability, tax savings, and no tax effect. This depends, of course, on the previous history of each capital asset sold. The distance between S'S' and SS represents not the capital gains tax to be paid by the profit takers, but a weighted average of the tax paid by all sellers, including those who pay no tax at all and those who pay a negative tax through tax savings in case of a loss.

The effect of the tax on the demand curve is more difficult to analyze. The prospect of having to pay a tax on a gain will probably dampen the demand somewhat. The prospective tax taken into account in this case will depend on the prospective capital gain. But there is no single prospective capital gain—rather a broad optimism among buyers that prices will rise. Nor is the prospect of a capital gain the sole factor in demand; the prospect of dividend, interest, or rental income is sometimes more important. Thus the imposition of a capital gains tax will reduce the demand to a limited extent. This is shown by D'D' in Figure 1. The distance between the DD and D'D' curves is some sort of weighted average (weighted by both amounts and probabilities) and will, of course, depend on the intentions of the buyers.

As a result of the decline in both demand and supply the amount of securities or property sold must decline—from OM to ON in Figure 1. But whether the asset price rises or falls will depend on the relative shifts of the two curves. The tax liability of sellers is something real, definite, and calculable by the sellers at each possible price at any time. The expected future tax liability of the buyers is, however, something very vague and indefinite and, in any case, is associated only with a very favorable contingency, namely profit-taking. It is likely, therefore, that the shift in the supply curve is greater than the shift in the demand curve. In that case the price would rise as a result of the tax, from *OP* to *OQ* in Figure 1. To this extent the capital gains tax is shifted from sellers to buyers. The rest

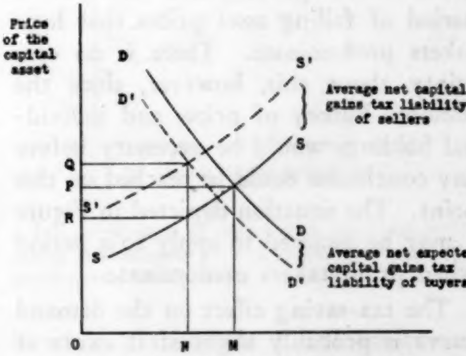

FIG. 1.—Shifting of capital gains tax when profit-taking predominates.

of the tax is absorbed by the sellers. This is the amount *RP* in Figure 1. The full amount of the tax paid, on the average, is *RQ*.

Significance of Capital Losses

The fact that capital losses may be offset against gains and income, to a certain limited extent, will have the opposite effect on the supply curve to that depicted in Figure 1. As pointed out above, the fact that a capital asset is sold at a loss may mean tax savings. This would tend to move the *SS* curve to the right and would offset to some extent the shift to the left caused by the profit-takers. In a period of rising asset prices it may be assumed that profit-takers predominate and in a period of falling asset prices that loss-takers predominate. There is no certainty about this, however, since the previous history of prices and individual holdings would be necessary before any conclusion could be reached on this point. The situation depicted in Figure 1 may be assumed to apply to a period when profit-takers predominate.

The tax-saving effect on the demand curve is probably slight if it exists at all. Since people seldom, if ever, buy with the expectation of a loss, the prospect of tax-saving must be very small and its influence on the demand curve may be considered negligible. The situation is depicted in Figure 2. The supply curve moves to the right as a result of the tax saving involved in loss taking. In other words, the seller is willing to sell a given amount of his capital asset at a lower price than he would otherwise, since he is selling at a loss and he will be able to deduct that loss in computing his tax (to a limited extent). If there is no offset and no prospect of it during a carry-over period this effect will not be felt. Since there are many sellers, some of them taking profits, the resultant shift in SS is some sort of weighted average. The vertical distance between SS and S′S′ at any price on S′S′ indicates the average net amount of tax saving resulting from the loss-taking.

The shift of the demand curve *DD* to the left in Figure 2 is assumed to be the same as in Figure 1. The fact that,

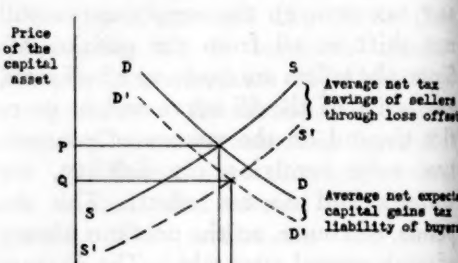

FIG. 2.—Shifting of capital gains tax when loss-taking predominates.

generally, losses are being taken does not necessarily increase the expectation of loss and, in fact, may have the opposite effect. In any case, the net expectation is probably still one of profit.

The price is certain to fall as a result of the shift of *SS* to the right and *DD* to the left. In Figure 2 the price has dropped from *OP* to *OQ*. The extent of the fall in price and the exact amount of capital assets sold at the new price is, however, dependent on the relative magnitudes of the two shifts. In Figure 2 it is assumed that the SS curve shifts to the right more than the *DD* curve shifts to the left. The amount of the capital asset sold therefore increases

from *OM* to *ON*. Far from there being any tax shifting through a price rise as a result of the imposition of a capital gains tax, there is a price fall in a period when loss-taking predominates. The seller receives some compensation from the government in the form of a tax saving through a loss offset. This compensation is measured by the vertical distance between the SS and S′S′ curves. The compensation will be more than the tax-induced price decline if the new equilibrium point is to the right of the old and less if it is to the left. This compensation benefits the present seller but does not otherwise modify the unfavorable effect which the accentuated price decline has on general business expectations.

Profit and Loss-Taking as Variables

There is a further refinement that should be made in the above analysis. Situations of predominant profit-taking and predominant loss-taking have been considered above. This was assumed to affect the *position* of the supply curve. At a high enough price, profit-taking may be assumed to predominate and at a low enough price loss-taking may be assumed to predominate. This would affect the *shape* of the supply curve. The situation is depicted in Figure 3. The imposition of a capital gains tax will result in a shift from SS to the type of curve shown by S′S′. At the higher prices the S′S′ curve is higher than the SS curve, indicating that sellers will want a still higher price to take care of the capital gains tax. At the lower prices the S′S′ curve is lower than the SS curve, indicating that sellers will be willing to accept a still lower price because of the tax savings they will have on account of their losses. At the point *B*, profit-takers exactly counterbalance loss-takers. If prices have been rising for some time there will be many profit-takers and the point *B* will be reached sooner, that is, it will move to the left. If prices have been falling for some time there will be many loss-takers and the point *B* will move farther to the right. Whether the final effect will be a price rise or fall will depend on the

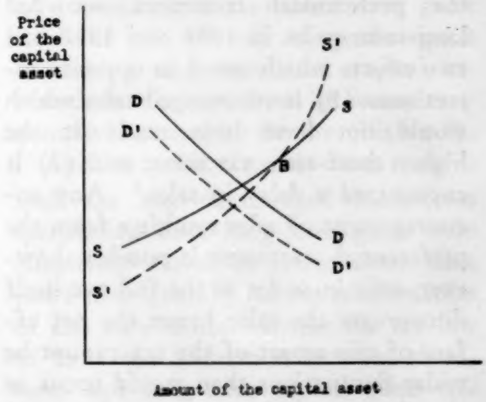

FIG. 3.—Shifting of capital gains tax when profit-taking predominates at high prices and loss-taking predominates at low prices.

location of the point B and the extent of the divergence between SS and S′S′ on both sides of the point *B*, in relation to the extent of the shift from *DD* to D′D′.

Distinction Between Short-Term and Long-Term Capital Gains

The present distinction in the American tax structure between long-term and short-term capital gains does not affect the above results qualitatively; it does, however, affect it quantitatively in specific cases. Since short-term gains are taxable as ordinary income while

long-term gains have a tax ceiling of 25 per cent (in effect), the over-all impact on the supply curve will depend partly on the number of short-term and long-term profit-takers as well as loss-takers. On the demand side, this distinction adds an additional element of vagueness since the buyer can hardly know whether he will be a short-term or long-term profit-taker — if he is a profit-taker at all.

Colm and Lehmann have argued that the preferential treatment accorded long-term gains in 1936 and 1937 had two effects which acted in opposite directions: (1) it encouraged sales which would not have been made at the higher short-term tax rates; and (2) it encouraged a delay in sales.[4] Any encouragement of sales resulting from the preferential treatment is possible, however, only in so far as the full tax itself discourages the sale; hence the net effect of this aspect of the tax cannot be wider fluctuations than would occur in the absence of the tax as a whole. If short-term holdings predominate, the shift from SS to S'S' in Figure 1 is greater than if long-term holdings predominate. Some shift takes place nevertheless and the analysis of Figure 1 applies. Whenever profit-taking predominates, sales will be less at high tax rates than at low rates. The high short-term rates may, therefore, prevent some sales which would occur if the low long-term rates prevailed. This does not mean that there will be a " delay " in the sense of a postponement merely until the short-term holdings mature into long-term holdings. Some short-term holdings will not be put on the market currently because of the high short-term rates but there is no telling when these holdings will be put on the market. At the time they become long-term holdings market conditions may be unfavorable to a sale even at the low long-term rates. In view of the general uncertainty concerning future market conditions, it is not likely that the mere fact of a low rate on long-term holdings in the future will affect the *current* demand and supply of assets in any significant way.

At any particular time, the existence of long-term holdings makes the shift from SS to S'S' in all cases less than it would be if all sales were taxable at the prevailing short-term rates. This means that the preferential treatment accorded long-term gains reduces the tendency of the capital gains tax to accentuate price increases when profit-making predominates. Similarly, it reduces the tendency of the capital gains tax to accentuate price declines when loss-making predominates. Thus the preferential provisions have a stabilizing effect which offsets to some extent the destabilizing effect of the capital gains tax as a whole.

Net Effect on Fluctuations in Price

The general conclusion to be derived from the tax shifting analysis in this paper is that the capital gains tax aggravates price rises and price falls. When prices are rising and profit-taking predominates the tax tends to encourage even higher prices than would

[4] *Cf.* Gerhard Colm and Fritz Lehmann, "Economic Consequences of Recent American Tax Policy," *Social Research*, 1938, Supplement I, pp. 67-68. The type of preferential treatment has changed since then but the principle remains unchanged. At that time there was an " aging " provision whereby a capital gain was considered taxable according to various percentages ranging from 100 per cent down to 30 per cent depending on the length of time the asset was held.

otherwise exist. When prices are falling and loss-taking predominates the tax tends to encourage even lower prices than would otherwise exist.

This leads to an important aspect of the effect of the tax. The fact that capital losses are allowed as offsets to capital gains or income (in certain cases) may appear to be a factor contributing to economic stability. Loss offsets are generally so regarded. As a matter of fact, it is not so at all in this case. Rather, the loss offset provisions of the capital gains tax tend to accentuate downswings. The tax on capital gains itself tends to accentuate upswings. The tax therefore seems to promote economic instability.

EFFECTS ON ECONOMIC GROWTH

It has been contended that the capital gains tax as it existed in 1936 and 1937 discouraged the making of risky investments.[5] It closed off some outlets for venture capital by reducing the net gain (i.e. gain after payment of the capital gains tax). As a matter of cold fact the tax does, of course, reduce the net gain but the maximum reduction in the case of long-term gains is now effectively 25 per cent. Moreover the present possibility of tax saving through loss offsets against other gains fully or income (up to $1,000 a year) over a five-year period may neutralize to a large extent any discouraging effect of the tax on risky investments. In view of the fact that overinvestment has often been the cause of business crises in the United States,[6] any dampening effect of the capital gains tax on risky investments at the peak of an upswing when profit-taking predominates cannot be condemned a priori.

It has also been asserted that new issues were especially hampered by the tax.[7] This is probably true in so far as the new issues are subscribed for out of old capital, thus necessitating the sale of securities or other assets. Since new issues subscribed for out of old capital do not increase the availability of capital for enterprise they are not of great concern. In periods of predominant loss-taking the amount of capital invested in the purchase of assets may even be increased by the tax (Figure 2).

Another point that has been made is that the tax discouraged short-term speculation since long-term gains were effectively taxed at lower rates than short-term gains.[8] Recent confirmation of this view exists. Under the tax law of 1948 the distinction between short-term and long-term capital gains was reduced indirectly through a material reduction in the tax rates on incomes of married couples. The reductions applied to short-term capital gains as to all other income. It was felt that increased activity in the stock market resulted directly from these changes.[9] Even if the tendency to discourage short-term as compared with long-term investments does exist (and our earlier analysis suggests that this may not be very important quantitatively), the social consequences may not be at all undesirable. There may be much to be said for encouraging stability in investments by giving preferential treatment

[5] Colm and Lehmann, *op. cit.*, pp. 52-53. At that time losses were deductible against gains and $2,000 of net income but there was no carryover.

[6] See Harold M. Somers, "Performance of the American Economy," chaps. 16 and 32 in *Growth of the American Economy* (H. F. Williamson, ed. New York: Prentice-Hall, 1944).

[7] Colm and Lehmann, *loc. cit.*

[8] *Ibid.*

[9] J. K. Lasser, "New Tax Law and Speculation," *Commercial and Financial Chronicle*, June 17, 1948, p. 8.

to long-term holdings. Moreover, the banking system is especially able to take care of short-term financing. A firm which is able to sell stock on the open market is usually able to arrange a short-term loan. It is the availability of capital for long-term investments that is of major importance.

What is the significance of these effects for economic growth? If cyclical instability had no effect on long-term trends the impact on economic growth would be small. Even under an unsympathetic interpretation of the above results it would seem that the capital gains tax discourages only slightly the purchase of capital assets and does not greatly discriminate against the riskier investments of a long-term nature. Cyclical instability and, especially, prolonged depressions may be very costly, however, for the growth of the economy. To the extent that the tax tends to promote instability it may retard the long-term growth of capital and thereby hamper progress.

CONCLUSIONS

The above analysis points to the capital gains tax as an element of instability. The analysis of tax shifting indicates that the tax accentuates price rises and price falls. At a time when prices are rising the tax promotes higher prices than would otherwise prevail. At a time when prices are falling the tax promotes lower prices than would otherwise prevail. The preferential treatment accorded long-term sales reduces the severity of these effects to some extent. The net effect, however, is that the tax accentuates upswings and downswings in security and other asset prices. The tax might also have some dampening effect on venture capital but this cannot be evaluated adequately except in the context of the general subject of business fluctuations. It is doubtful, moreover, whether there is any dampening effect at all. The destabilizing effect of the tax through its accentuation of price fluctuations is, however, of considerable importance; and in so far as cyclical fluctuations retard the long-term trend of capital formation, the capital gains tax may be said to have a detrimental effect on economic growth.

The generally unfavorable conclusion does not necessarily mean that the capital gains tax should be repealed. Under our present tax system, whereby so many individuals and so many activities are subject to taxation, considerations of equity may dictate that the process of making a living through capital gains be not allowed to go tax-free. Moreover, if orthodox methods of finance are employed, alternative sources of revenue have to be discovered and evaluated before a decision can be taken on the repeal of this or any other tax.

FINANCING OF STATE VETERANS' BONUSES

HENRY D. MORGAN *

World War I Bonuses

AFTER World War I, twenty states passed veterans' bonus laws.[1] Benefit provisions differed, but most states provided for the payment of $10 for each month of active domestic service and $15 for each month of active overseas service. The maximum amount that a veteran could collect from his state ranged from $100, in five states, to $845, in one state.[2]

The bonuses were financed in three ways. Sixteen states issued bonds. Three states levied special taxes. Only one state paid the bonus from general appropriations.

The precedent set by the states after World War I was responsible for the many bonus bills introduced into the various state legislatures after World War II. It is significant that to date far fewer states have passed bonus laws than after World War I. This can perhaps be attributed to the fact that bonuses have taken on a bad connotation as the result of the long struggle for a Federal bonus after the first World War, and also to the fact that aid to veterans has been directed into other channels, such as hospitalization, college scholarships, vocational rehabilitation, and home and farm loans. The lack of interest in the bonus in many states may be due to the greater dependence upon Federal aid to veterans, which has been comprehensive and generous.[3]

World War II Bonuses

Up to June 30, 1948, nine states had enacted bonus laws for the benefit of veterans of World War II. These states were: Connecticut, Illinois, Massachusetts, Michigan, New Hampshire, New York, Ohio, Rhode Island, and Vermont.

The following eight states had passed laws submitting the bonus issue to referendum in the Fall of 1948: Indiana, Iowa, Louisiana, Minnesota, Missouri, North Dakota (June), South Dakota, and Wisconsin.[4] Pennsylvania's bonus law must be passed by two successive legislatures before being submitted to referendum. It passed the 1947 legislature for the first time. It

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[1] See *State Veterans' Laws*, Committee on Pensions, House of Representatives, 79th Cong., 1st sess., 1946.

[2] The following states used the $100 maximum: Maine, Massachusetts, New Hampshire, New Jersey, and Rhode Island. Kansas set the $845 maximum.

[3] It is reported that the Federal contributions to veterans' benefits during the four-year period beginning with 1946 will approximate $1,450 per person who saw service in the armed forces during World War II, as compared with expenditures of about $400 per man over a similar period beginning in 1919. See Tax Foundation, *Cash Bonuses for Veterans* (New York, 1948), p. 3.

[4] The North Dakota referendum was held June 29, 1948, but the results were not available at the time of this writing.

now awaits passage in the 1949 legislature and if passed will then be submitted to the voters in the Fall of 1949.

Bonus legislation was introduced into the legislatures of the following thirteen states but failed in one or both of the houses of the legislature: Alabama, Colorado, Delaware, Florida, Georgia, Maryland, Mississippi, Nebraska, New Jersey, Oklahoma, South Carolina, Texas, and Washington.

Maine's bonus law was defeated in referendum in September, 1946. It failed of repassage in the 1947 legislature.

The remaining sixteen states have taken no action upon the bonus question to date.

General Provisions.—The bonus laws provide that the bonus is to be paid to veterans of World War II who have served a certain minimum length of time in any of the branches of the armed forces of the United States and who were discharged under honorable circumstances. All states require a minimum period of residence within their borders both before induction and after discharge in order to qualify for the bonus. Many of the states provide for payment of the bonus to the surviving relatives of a deceased veteran.

Size of Payments.—All of the bonus-paying states, except Rhode Island, graduate the amount of the bonus payment according to the length of time in the service and/or according to whether the service was rendered domestically or overseas. Three of the states provide for the payment of $10 for each month of domestic service and $15 for each month of overseas service. Of these states, Ohio imposes a $400 maximum; Michigan, a $500 maximum. The Illinois bonus is limited only by the limits of the eligible time —September 16, 1940, to September 2, 1945. Three other states provide for the payment of a flat $10 per month regardless of where the service was performed. Of these states, New Hampshire imposes a $100 maximum, Vermont a $120 maximum, and Connecticut a $300 maximum. Of the remaining three states, New York provides for the payment of $50 for domestic service of sixty days or less, $150 for domestic service of over sixty days, and $250 for service of any duration overseas. Massachusetts provides for the payment of $200 for domestic service of six months' duration, and $300 for six months' service including some time overseas. Rhode Island provides for the payment of a flat $200 for a minimum of ninety-one days of service, regardless of where performed.

Methods of Financing the Bonuses

Connecticut.—The Connecticut law authorized the issuance of $50 million in serial bonds to be known as "The World War II Bonus Bonds of the State of Connecticut." The bond issue is to be administered by a special commission known as the "Veterans' Bonus Commission," consisting of the Governor, the State Treasurer, and the State Comptroller. The bonds are to be sold at public sale to the best bidder, but at not less than par. They are to mature in substantially equal installments, beginning approximately one year from their date of issue, and are to be retired within ten years. Both the principal and interest of the bonds are exempt from State taxation. Notes are authorized in anticipation of the receipt of funds from the sale of the

bonds.[5] The State Treasurer is authorized to temporarily invest the funds received from the bond sales in obligations of the United States Government.[6] The bond issue was approved in a referendum in November, 1946.

No special taxes were earmarked for the retirement of the bonds; however, Connecticut adopted a State sales tax in 1947.

Connecticut adopted a second bonus law authorizing the payment of the bonus to parents of deceased veterans and providing for a special bond issue of $1,750,000 for that purpose.[7]

Long-term bonds in the amount of $50 million were sold in June, 1947, at 1.045 per cent interest.[8]

Illinois. — The Illinois bonus law authorizes the issuance of $385 million in long-term serial bonds. The issuance, sale, and retirement of the bonds are under the supervision of the specially created "Service Recognition Board," consisting of the Governor, the State Treasurer, and the Adjutant General.[9] The bonds are to be sold at public sale to the best bidder, at not more than 2 per cent interest, and the proceeds are to be paid into a special fund to be known as "The Illinois Compensation Fund." The bonus payments and bond issues were approved in referendum in November, 1946.

Long-term serial bonds in the amount of $300 million were sold in April, 1947, at 1.67611 per cent interest.[10] An additional $85 million of long-term serial bonds were sold in February, 1948, at 1.948 per cent interest.[11]

The bonds must be retired within twenty-five years.[12] Two special taxes have been levied for that purpose. The first is a 4 per cent tax upon all monies wagered in pari-mutuel betting and one-half of the betting breaks.[13] The second is an additional tax upon cigarettes, at the rate of one-half mill per cigarette (1 cent per package of twenty).[14] Both taxes became effective January 1, 1947. An annual direct property tax is also authorized, if the revenues from these taxes prove insufficient.

Massachusetts.—Massachusetts enacted two bonus laws, the first in 1945 and the second in 1946.[15] The second law liberalized the bonus payments provided by the 1945 law and re-enacted at lower rates the special business taxes levied to retire the bonus bonds. A third act passed in 1946 authorized the issuance of $100 million of long-term serial bonds, the

[5] *Connecticut Session Laws*, 1947, Public Act No. 13.

[6] *C.S.L.*, 1947, Public Act No. 271, sec. 1.

[7] *C.S.L.*, 1947, Public Act No. 505, sec. 2.

[8] *The Bond Buyer*, Vol. 115, July 26, 1947 (pink supplement, p. 5).

[9] *Illinois Session Laws*, 1946, chap. 126½, sec. 53.

[10] *The Bond Buyer*, Vol. 114, May 17, 1947 (pink supplement, p. 6).

[11] *Ibid.*, Vol. 116, March 13, 1948 (pink supplement, p. 6).

[12] The act also authorizes the issuance of short-term notes in anticipation of bond receipts. Of the $300 million issue, $150 million were sold for terms from two to thirteen years and $150 million for terms from fourteen to twenty-five years. Of the $85 million, $30.8 million were sold for an average term of three and two-thirds years and $54.2 million for an average term of eight and one-fourth years.

[13] *I.S.L.*, 1946, chap. 8, sec 37f. This tax is levied in addition to the existing 2 per cent pari-mutuel betting tax.

[14] *I.S.L.*, 1946, chap. 120, secs. 453.2, 453.29.

[15] *Massachusetts Session Laws*, 1945, chap. 731; *M.S.L.*, 1946, chap. 581.

proceeds of which are to be paid into a special account to be known as "The Veterans' Service Fund." The bonds are to be made payable not later than June 30, 1956.[16] The act also authorizes one-year anticipation notes.[17]

Long-term serial bonds in the amount of $25 million were sold in June, 1947, at 1.021 per cent interest.[18] Additional long-term serial bonds in the amount of $50 million were sold in September, 1947, at 1.063 per cent interest.[19]

Three special taxes were levied to provide funds for the bonus and bond retirement. The proceeds of these taxes are to be paid into the special "Veterans' Service Fund." The first tax was an additional excise on cigarettes at the rate of 1 mill per cigarette sold after August 1, 1945. It was also provided that one-third of the existing tax of 3 cents per pack be set aside for the purposes of the act.[20] The second special tax was an additional tax on wine and whiskey levied at the rate of 50 cents per gallon. This tax also went into effect August 1, 1945.[21] The third special tax under the 1945 bonus law was an additional net income tax upon all domestic and foreign manufacturing and business corporations at the rate of 2.5 per cent of their net income. The rate was dropped to 1.5 per cent in the 1946 bonus law. This tax is to remain in effect until 1950.[22]

It is expected that the cost of the bonus to the State will be in the neighborhood of $165 million, excluding the costs of administration.[23]

Michigan.—The Michigan law authorized the issuance of $270 million in long-term serial bonds, to be known as "Veterans' Bonds." They are to bear interest at a rate not to exceed 2.5 per cent per annum. The bonds are to mature in annual installments of not less than $10 million each, beginning one year from their date and ending not later than 1968. They are callable upon terms prescribed by the State administrative board.[24] The bonds are to be sold at public sale to the best bidder, and the proceeds are to be deposited in a special fund to be known as "The Veterans' Military Pay Fund." The principal and interest of the bonds are exempt from State and municipal taxation. The bond issue required an amendment to the Michigan Constitution. This amendment was ratified by the voters in November, 1946.

Long-term serial bonds in the amount of $200 million were sold in March, 1947, at 1.4734 per cent interest,[25] and $30 million more in September, 1947, at 1.22009 per cent interest.[26]

16 *M.S.L.*, 1946, chap. 608, sec. 1.

17 *M.S.L.*, 1946, chap. 731, sec. 7.

18 *The Bond Buyer*, Vol. 115, July 26, 1947 (pink supplement, p. 7).

19 *The Bond Buyer*, Vol. 115, October 25, 1947 (pink supplement, p. 7). In addition to these long-term bonds, $80 million in one-year notes were sold in 1946, and $30 million more one-year notes were sold in 1947.

20 *M.S.L.*, 1945, chap. 731, sec. 9.

21 *Ibid.*, sec. 11.

22 *Ibid.*, sec. 10. Also *M.S.L.*, 1946, chap. 581, sec. 5-a.

23 Council of State Governments, *State Veterans Legislation Enacted During 1946* (Chicago, 1946), pp. 24-28.

24 *Michigan Session Laws*, 1947, Act No. 4, sec. 1. Three-year serial notes and temporary bonds were also authorized.

25 *The Bond Buyer*, Vol. 114, April 26, 1947 (pink supplement, p. 7).

26 *Ibid.*, Vol. 115, October 25, 1947 (pink supplement, p. 7).

The law authorizes special taxes which are to be deposited in a special account to be known as "The Veterans' Bond Redemption Fund," but to date no special taxes have been levied. However, Michigan adopted a cigarette tax of 3 cents per pack in 1947.

New Hampshire.—The New Hampshire bonus law authorized the issuance of $4 million in bonds.[27] The law was not submitted to referendum, but was passed as an emergency measure.

Bonds in the amount of $3.9 million were sold privately but they have been retired from the State sinking fund.[28] A second issue of $1.5 million was sold in February, 1948, at 1.654 per cent interest.[29]

New Hampshire levied a poll tax to retire the bonds.[30] The tax rate was $3 per person, except upon veterans, who were exempt. The tax was collected only for the fiscal years beginning April 1, 1944, and April 1, 1945. It was repealed in May, 1945.[31]

New York.—The New York law authorized the issuance of $400 million in long-term serial bonds to be known as "War Bonus Bonds." The first of these bonds are to be payable within one year and the last not later than January 1, 1958.[32] The bonds are to be sold at public sale to the best bidder, but no more than 5 per cent interest may be paid. The proceeds of the bonds are to be paid into a special account to be known as "The War Bonus Fund." The principal and interest of the bonds are exempt from State taxation. The bonus payments themselves are also exempt. The bonus and bond issues necessitated a change in the New York Constitution. This change was approved by the voters in November, 1947.

Long-term serial bonds in the amount of $300 million were sold in March, 1948, at 1.79375 per cent interest.[33] They are to mature at the rate of $30 million per year from January 1, 1949, through January 1, 1958. In January, 1948, one-year notes in the amount of $100 million were sold.[34] Thus, the State has reached its limit of indebtedness under the act.[35]

A number of special taxes were levied to retire the bonds. The first was an additional tax upon cigarettes at the rate of 1 per cent per pack, effective January 1, 1948.[36] The second tax was an additional personal income and capital gains tax levied at the rate of 10 per cent of the existing rates of these taxes.[37] The proceeds of both special taxes are to be paid into a special fund known as "The War Bonus Account."

Ohio.—The Ohio law authorized the Commissioners of the Sinking Fund to

[27] *New Hampshire Session Laws*, 1943, chap. 201, sec. 6.

[28] *The Bond Buyer*, Vol. 114, March 15, 1947, p. 8.

[29] *Ibid.*, Vol. 116, March 13, 1948 (pink supplement, p. 8).

[30] *N.H.S.L.*, 1943, chap. 201, sec. 5.

[31] *N.H.S.L.*, 1945, chap. 157.

[32] *New York Statutes*, 1947, title 28, sec. 10202.

[33] *The Bond Buyer*, Vol. 116, April 17, 1948 (pink supplement, p. 10).

[34] *Moody's Bond Survey*, February 23, 1948, p. 613.

[35] These bond flotations roughly double the net indebtedness of the State of New York. *Moody's Bond Survey*, February 23, 1948, p. 613.

[36] *New York State Tax Code*, sec. 471-a.

[37] *Ibid.*, sec. 351-b.

sell long-term serial bonds to the extent of $300 million. They are to mature in thirty semi-annual installments. No bonds are to be dated later than April 1, 1951. The bonds are to be sold at public sale to the best bidder at rates of interest fixed by the Commissioners. The proceeds of the bond sales are to be paid into the special account, "The World War II Compensation Fund." The bonds and the interest thereon are exempt from all State taxes. The bond issues required an amendment to the Ohio Constitution. It was approved by the voters in November, 1947.

Long-term serial bonds in the amount of $200 million were sold in March, 1948, at 1.9289 per cent interest.[38] Their average term was eight years.

A property tax is authorized to provide funds to retire the bond issue. The revenues received from this tax are to be paid into the special "World War II Compensation Bond Retirement Fund."

Rhode Island.—The Rhode Island bonus law authorized the issuance of $20 million in long-term serial bonds to be known as "The 1946 Veterans' Bonus Loan." The bonds are to bear interest, not to exceed 1.5 per cent per year, and are to mature not later than January 1, 1968.[39] The bonds may be sold publicly or to the State sinking fund. The proceeds of the sale are to be paid into the special account, "The 1946 Veterans' Bonus Loan Fund." The interest accruing to this account is to be made a part of the general funds of the State. The bonds are exempt from all State taxation. The bonus law was approved by the voters in referendum in November, 1946.

Long-term serial bonds in the amount of $20 million were sold in November, 1946, at 1.287 per cent interest.[40] Of this amount, $19.5 million was for the payment of bonuses to veterans of the armed forces; the balance was for the payment of a bonus to ex-members of the merchant marine who served in wartime. The two issues were sold together for terms of from one to twenty years.

No special taxes were levied to retire the bonds, although in 1947 Rhode Island levied a sales tax and a new corporate income tax of 4 per cent.

Vermont.—The Vermont bonus law authorized no bonds nor special taxes. The cost of the bonuses is to be paid from treasury surpluses.[41] By March, 1948, Vermont had spent $3 million for the bonus payments.[42]

Summary of Financing Provisions

Special Bond Issues.—Eight of the nine bonus states authorize the issuance of bonus bonds.[43] In all but New Hampshire the bonds are required to be in serial form. New York is the largest borrower with an authorization of $400 million. New Hampshire is the smallest with an authorization of $4 million. The total value of the

[38] *The Bond Buyer,* Vol. 116, April 17, 1948 (pink supplement, p. 11). The need for further bond issues in this State has been decreased by the appropriation of $25 million in the 1947 regular session of the State legislature, and of $20 million in the special session of 1947, from the general funds of the State.

[39] *Rhode Island Session Laws,* 1946, chap. 1721.

[40] *The Bond Buyer,* Vol. 113, December 14, 1946 (pink supplement, p. 10).

[41] *Vermont Session Laws,* 1941, Public Act 179.

[42] Tax Foundation, *Cash Bonuses For Veterans* (New York, 1948), p. 4.

[43] Vermont was the only state that did not authorize bonds.

authorized bonds, as shown in the accompanying table, is approximately 1.5 billion.

Tax Exemptions.—Five of the eight states which issue bonds exempt them from taxation by the state.[44] Four of the five exempt the income from the bonds.[45]

Interest Rates.—The lowest authorized maximum interest rate is Rhode Island's 1.5 per cent. The highest is New York's 5 per cent. Four of the states left the maximum interest rate to the discretion of administrative officials.[46] The highest interest rate actually paid by any of the eight states was 1.948 per cent by Illinois on its $85 million issue in February, 1948. The lowest interest rate was 1.021 per cent paid by Massachusetts on its $25 million issue in June, 1947.

Special Bonus Accounts.—In all of the eight bond-issuing states the proceeds of the bonds are paid into special funds. The bonus claims are to be paid from these accounts.

Special Bond Retirement Funds.—Seven of the states have set up special bond retirement accounts in their treasuries. Michigan to date has not levied any special taxes, therefore, has not made use of the special fund provision in its bonus law. The Rhode Island law makes no provision for a special fund.

VETERANS' BONUS BOND AUTHORIZATIONS AND SALES, AS OF JUNE 30, 1948
(In Thousands of Dollars)

State	Bonds and Notes Authorized	Bonds Sold	Notes Sold
Connecticut	$ 51,750	$ 50,000	......
Illinois	385,000	385,000	......
Massachusetts	100,00 [a]	75,000	$110,000
Michigan	270,000	230,000	......
New Hampshire	4,000	1,500 [b]	350
New York	400,000	300,000	100,000
Ohio	300,000	200,000	......
Rhode Island	20,000	20,000	......
Total	$1,530,750	$1,261,500	$210,350

[a] The Massachusetts statutes imposed no ceiling on one-year notes.

[b] New Hampshire has floated a total of $5,400,000 in bonus bonds. The first issue of $3,900,000 was privately sold and was retired before the February, 1948, issue of $1,500,000, which was part of a larger flotation of a total of some $5,290,000.

Short Term Notes.—Six of the nine states authorize the issuance of short-term notes.[47] Ohio and Rhode Island authorize only long-term serial bonds.

Rate of Bond Retirement.—Illinois has the longest specifically authorized term, that of twenty-five years. Massachusetts has the shortest time limit, June 30, 1956. New Hampshire left the retirement date to be determined by the Governor and Council.

Callability.—Of the $1,261.5 million of bonds sold to date, $193 million are callable before maturity. This leaves a total of $1,068.5 million in long-term bonds which are not subject to call before their maturity dates.

[44] Connecticut, Michigan, New York, Ohio, and Rhode Island.

[45] Connecticut, Michigan, New York, and Ohio.

[46] Connecticut, Massachusetts, New Hampshire, and Ohio.

[47] Connecticut, Illinois, Massachusetts, Michigan, New Hampshire, and New York.

Special Taxes. — Six of the states authorize the levying of special taxes to retire their bond issues and to pay the bonuses.[48] Michigan is the only state authorized to levy a special tax which, to date, has not done so. Connecticut and Rhode Island are using general revenues to retire their bonds.

Constitutional Amendments. — The bonuses and bond issues required constitutional amendments in Michigan, New York, and Ohio. In each case the amendment was voted upon at the polls.

Referenda.—In all of the states except Massachusetts, New Hampshire, and Vermont the bonus question was voted upon by the electorate. In Massachusetts and New Hampshire the acts were passed as emergency measures.

[48] Illinois, Massachusetts, Michigan, New Hampshire, New York, and Ohio.

Economic Effects of the Bonuses

The payment of more than $1.5 billion of state veterans' bonuses since the end of the war has undoubtedly added to existing inflationary pressures. The bonuses have been financed largely by sale of bonds to wealthy individuals and institutions likely to be attracted by long-term tax-exempt securities of high quality. The vast majority of bonus recipients are persons of modest means who are likely to spend their bonus money almost immediately. The transfer of purchasing power brought about by the bonus payments has undoubtedly increased current consumption expenditures. The special taxes levied to retire the bonds are an offsetting influence but, geared as they are to the lives of the bonds, their immediate impact has been relatively light.

INCOME TAX DEDUCTIBILITY

HERBERT E. KLARMAN *

THIS PAPER examines two of the many criticisms levelled against the state individual income tax. The two criticisms are: (1) the state tax adds substantially to the heavy burden imposed by the Federal income tax; (2) it promotes sizable differentials in tax liability among residents of the several states. The first aspect is alleged to result in nearly confiscatory burdens on taxpayers, the second to promote tax-induced migration.[1]

The analysis which follows seems to prove, however, that under a federal system of government, the device of income tax deductibility tends to minimize differentials in total income tax liability between residents of the various states.[2] This tendency holds true even if the income tax deductibility provision is granted only by the federal government and is refused by the state; or conversely, is granted only by the state and is refused by the federal government. The tendency is particularly operative when income tax deductibility is mutually granted, i.e., both the federal government and the state allow the deduction of the income tax liability owed to the other jurisdiction.

Income tax deductibility also tends to protect the taxpayer against a combined (federal and state) confiscatory tax burden, so long as neither the federal income tax nor the state tax is independently confiscatory.

While other countries, such as Australia and Canada, have had experience with income tax deductibility, this paper restricts the analysis to the American scene, which features high and progressively graduated Federal income tax rates, low state rates, and Federal deductibility. If the analysis is valid, there appears to be no need for outright repeal of state income taxes. It points, instead, to the possibility of instituting simple and effective reform measures.

The Interstate Tax Differential

The Federal provision for the deduction of state income tax liability in computing Federal net taxable income reduces the effective burden on the taxpayer, and does so in a pronounced fashion. Even if the states choose not to reciprocate and fail to allow the deduction of Federal tax liability in computing state net taxable income,[3] the

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[1] In the absence of tax differentials, taxation cannot be said to induce migration. That migration would follow, if tax differentials did exist, is certainly a debatable conclusion.

[2] See Committee on Intergovernmental Fiscal Relations, *Federal, State and Local Government Fiscal Relations*, Senate Document No. 69, 78th Cong., 1st Sess. (1943), pp. 437-48.

[3] At this time, twenty-two states allow deductibility and nine do not. The latter group consists of California, Maryland, Mississippi, New Hampshire, New York, North Carolina, South Carolina, Tennessee, and Virginia. In the former group, Massachusetts and Wisconsin allow only limited deductibility.

unilateral Federal grant lowers the effective Federal, and consequently the effective total, rate of income tax on every individual subject to state income taxes. The effect is to reduce substantially the differential in tax burden between residents of income-tax and non-income-tax states. If the states do reciprocate, the tax differential declines still further, almost vanishing in the top rate brackets.

The size of the differential, best expressed as a percentage of or an effective rate on net income, is a function of these variables:

(1) It is smaller under reciprocal than under unilateral deductibility.

(2) It varies directly with the level of the state rate structure. Low state rates cannot produce large interstate tax differentials.

(3) It varies inversely with the height of the Federal rates.

(a) Within a given progressive Federal rate structure, the differential increases at first and then declines at a certain income level, where the rising Federal rates "overwhelm" the constant state rates.

(b) If the entire Federal rate structure moves upward (downward), the size of the differential decreases (increases) at every income level.

These generalizations are illustrated numerically by comparing differential tax burdens on residents of Minnesota under the Federal tax rate structures of 1940, 1941, 1946, and 1948.[4] Minnesota was chosen because it is now one of the leading income-tax states, featuring low personal exemptions and relatively high rates for a state income tax. With a 10 per cent maximum rate imposed at $20,000, it ranks second only to North Dakota in this respect. While the Minnesota law grants reciprocal deductibility, the computations which follow assume alternatively that deductibility is denied.

Table 1 shows combined tax liabilities, expressed as effective rates on income, for Federal and state income taxes in 1940, 1941, 1946, and 1948, under unilateral (Federal) and reciprocal deductibility and corresponding differentials over liability for Federal tax only

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[4] They may also be expressed symbolically.

Let R = Federal tax rate, expressed as an effective rate on income.

r = state tax rate, expressed as an effective rate on income.

Then, assuming *proportional* Federal and state rates, the interstate tax differential for a resident of an income-tax state which does not grant deductibility is:

$$D = r(1 - R) \quad \dots\dots \quad (1)$$

and the interstate tax differential for a resident of an income-tax state which does grant deductibility is:

$$D^1 = \frac{r(1 - R)^2}{1 - rR} \quad \dots\dots \quad (2)$$

Propositions 2 and 3 are evident.

Proposition 1 holds if $D \geqq D^1$, or if $1 - R \geqq \frac{(1 - R)^2}{1 - rR}$.

Multiplying both sides of the inequality by $\frac{1 - rR}{1 - R}$, we obtain $1 - rR \geqq 1 - R$. Q.E.D.

To prove that these propositions hold under progressive rates, let:

Subscript 1 refer to a non-income-tax state;

Subscript 2 refer to an income-tax state which does not grant deductibility;

Subscript 3 refer to an income-tax state which does grant deductibility.

Then, the interstate tax differential for a resident of an income-tax state which does not grant deductibility is:

$$D_2 = r_2 + R_2 (1 - r_2) - R_1 \quad \dots\dots \quad (3)$$

and the interstate tax differential for a resident of an income-tax state which does grant deductibility is:

$$D_3 = \frac{r_3(1 - R_3)}{1 - r_3R_3} + \frac{R_3(1 - r_3)}{1 - r_3R_3} - R_1 \quad \dots\dots \quad (4)$$

where $R_1 \geqq R_2 \geqq R_3$ and $r_2 \geqq r_3$.

The author is particularly indebted to Dr. Pechman for assistance in formulating the above.

TABLE 1

COMBINED FEDERAL AND STATE INCOME TAX LIABILITY AND INTERSTATE TAX DIFFERENTIAL, EXPRESSED AS PER CENT OF INCOME, FOR MARRIED RESIDENT OF MINNESOTA WITHOUT DEPENDENTS, AT SELECTED NET INCOME LEVELS IN 1940, 1941, 1946, AND 1948

Net Income and Year	Combined Liability			Federal Liability in Non-Income-Tax State	Interstate Differential	
	No Deductibility	Unilateral Deductibility	Reciprocal Deductibility		Unilateral Deductibility	Reciprocal Deductibility
(1)	(2)	(3)	(4)	(5)	(6)	(7)
1940						
$ 3,000	1.2%	1.2%	1.2%	0.9%	0.3%	0.3%
5,000	3.2	3.2	3.1	2.0	1.2	1.1
20,000	16.3	15.1	14.3	10.6	4.5	3.7
100,000	48.6	43.4	41.6	39.5	3.9	2.1
1,000,000	78.5	71.0	69.4	68.6	2.4	0.8
5,000,000	85.9	78.1	76.5	75.9	2.2	0.6
1941						
$ 3,000	4.9%	4.9%	4.9%	4.6%	0.3%	0.3%
5,000	8.7	8.5	8.4	7.5	1.0	0.9
20,000	28.8	26.5	25.2	23.1	3.4	2.1
100,000	61.8	55.6	54.0	52.7	2.9	1.3
1,000,000	83.2	75.4	73.9	73.3	2.1	0.6
5,000,000	88.5	80.4	78.8	78.4	2.0	0.4
1946						
$ 3,000	13.7%	13.5%	13.2%	12.7%	0.8%	0.5%
5,000	18.4	17.9	17.2	16.0	1.9	1.2
20.000	38.7	35.3	33.7	32.0	3.3	1.7
100,000	72.4	64.7	63.7	63.1	1.6	0.6
1,000,000	93.9	85.3	84.2	84.0	1.3	0.2
5,000,000	96.0	87.3	86.2	86.0	1.3	0.2
1948						
$ 3,000	11.0%	10.8%	10.5%	10.0%	0.8%	0.5%
5,000	15.0	14.6	14.1	12.6	2.0	1.5
20,000	27.9	25.9	24.5	21.2	4.7	3.3
100,000	55.7	49.8	48.2	46.4	3.4	1.8
1,000,000	86.9	79.8	77.4	77.0	2.8	0.4
5,000,000	91.1	82.9	81.4	81.1	1.8	0.3

in a non-income-tax state at selected net income levels.[5]

A comparison of columns 6 and 7 in Table 1 bears out proposition 1 and 3a. An intertemporal comparison within column 6 or column 7 bears out proposition 3b,[6] since the Federal rate structure was at a higher level in 1941 than in 1940, still higher in 1946, and lower in 1948.[7] Proposition 2 is self-evident.

In practice, tax differentials are not nearly so great as the deductibility computations in Table 1 indicate. The

[5] Liability is computed for a married man without dependents who is entitled in Minnesota to a personal tax credit of $30. The Federal standard deduction of 10 per cent of adjusted gross income, with the current upper limit of $1,000, is not taken into consideration. The net income levels show net income before personal exemption (or tax credit) and prior to allowable deductions for income taxes.

[6] The small increases in the interstate tax differentials at the $3,000 and $5,000 net income levels in 1946 over 1941 and 1940 are attributable to increases in state rates.

[7] The effect of the community property provision of the Revenue Act of 1948 is to reduce the effective Federal tax rate in the middle income brackets, increasing thereby the interstate tax differential. These effects are additional to the tax reduction in all income levels attributable to the allowances of 17, 12, and 9.75 per cent on the tentative tax liabilities computed under the 1945 rates.

computations assume that all income is earned income, and that the efficiency of state tax administration approaches that of Federal administration. Insofar as state administration is inferior [8] and special concessions are given to property income,[9] the actual state tax is below the computed state tax and the actual combined state and Federal income tax liability is lower than the computed combined liability.

Confiscation

The behavior of the interstate tax differential under tax deductibility suggests a corollary: the combination of Federal and state tax rates cannot be confiscatory, so long as neither rate is independently confiscatory.[10] Thus, the sum of a maximum Federal rate of 90 per cent and a maximum state rate of 15 per cent seems to be confiscatory. Actually, it is not. Although the combined tax liability must exceed either of its components computed in the absence of tax deductibility, it is well below the sum of the nominal rates and hence below the point of confiscation. Combined tax liability is 91.5 per cent under unilateral deductibility and 90.1 per cent under reciprocal deductibility.

A high Federal rate increases the danger of confiscation, but it simultaneously reduces the additional cost to the taxpayer of the state tax as it enhances the advantage derived by him from tax deductibility. Under high Federal tax rates, the combined Federal and state tax liability in an income-tax state scarcely exceeds Federal tax liability in a non-income-tax state, especially under reciprocal tax deductibility.

Since tax deductibility minimizes interstate tax differentials most effectively if Federal rates are high, it has never exerted any significant influence in the lower income brackets, where Federal rates have been low. Adoption in recent years of a standard 10 per cent deduction allowance with an upper limit of $500 ($1,000 under the Revenue Act of 1948) for purposes of computing Federal income tax liability has rendered income tax deductibility practically inoperative in the range of incomes below $5,000 as well as for a majority of all incomes up to $10,000.[11] For taxpayers who find election of the standard Federal deduction advantageous, the interstate tax differential equals precisely the state tax liability. However, tax differentials in these income brackets appear not to loom nearly

[8] Walter W. Heller, *State Income Tax Administration*, Ph.D. Dissertation, University of Wisconsin, 1941.

[9] The nontaxability of dividends derived from income already taxed by the state, the advantageous treatment of capital gains, and the exclusion of interest on government securities tend to lower the tax burden nominally imposed on large incomes.

[10] The symbols are borrowed from footnote 4.

Prove: (a) the combined income tax liability under unilateral (Federal) deductibility cannot be confiscatory, if neither tax rate is independently confiscatory. That is, prove:

(1) $R + r - rR < 1$, if $0 \leq R < 1$, $0 \leq r < 1$

(2) Divide by r: $\frac{R}{r} + 1 - R < \frac{1}{r}$

(3) Transpose: $\frac{1-R}{1} < \frac{1-R}{r}$. Q.E.D.

(b) Prove this proposition for reciprocal deductibility. Prove:

(1) $\frac{R(1-r)}{1-rR} + \frac{r(1-R)}{1-rR} < 1$

(2) Combine $\frac{R+r-2rR}{1-rR} < 1$

(3) Multiply by $1 - rR$: $R + r - 2rR < 1 - rR$

(4) Transpose: $R + r - rR < 1$

(5) Repeat proof in (a). Q.E.D.

[11] Based on U.S. Treasury Department, *Treasury Bulletin*, March, and April, 1946, p. A-12 and on unpublished memoranda.

so large when converted into absolute dollar amounts.

Subsidization

The deductibility feature causes the Federal Government to share the income tax liability of a taxpayer in an income-tax state. A portion of the taxpayer's state liability is offset by a reduction in his Federal liability; since the Federal Government collects less revenue from the same income in an income-tax than in a non-income-tax state. The Federal contribution is somewhat smaller if the state extends reciprocal deductibility. In either case, this is tantamount to a subsidy to the states from the Federal treasury.

As Federal tax rates increase, Federal deductibility absorbs a large percentage of the state tax, i.e., the Federal portion of the state tax rises in relation to the taxpayer's portion, the latter constituting the interstate tax differential. The reason is that rising Federal rates persistently press down on the interstate tax differential. The remaining component of the state tax, the portion met by the Federal treasury, necessarily takes up the slack.

Whether the fact that Federal deductibility absorbs a larger percentage of the state tax also means that Federal participation equals an increasing percentage of the taxpayer's income, depends on two characteristics of the state income tax: its deductibility policy and the degree of progression in its rate structure. If the state does not grant deductibility, the state tax liability, as a percentage of the taxpayer's income, increases (or remains constant) as income rises. Therefore, Federal participation increases as a percentage both of state tax liability and of the taxpayer's income. Under reciprocal deductibility, however, the state liability declines as a percentage of the taxpayer's income beyond a given point. Therefore, at some point in the income scale, Federal participation decreases as a percentage of the taxpayer's income, even though it constitutes an increasing fraction of state tax liability.

Similarly, an upward shift in the Federal rate structure produces increased relative (percentage) Federal participation in meeting state tax liability. Under unilateral deductibility, the Federal portion of state tax liability becomes a larger percentage of a constant base and therefore increases in amount, expressed as an effective rate on income. Under reciprocal deductibility, the Federal portion becomes a larger percentage of a declining base. In the lower income brackets, the rate of increase in relative Federal participation exceeds the rate of decrease in state tax liability. In the upper income brackets, on the other hand, the rate of increase in relative Federal participation is less than the rate of decrease in state tax liability. This result is due to the heavier impact of the increased Federal rates on the interstate tax differential in the lower income brackets, where the differential is sizable, than in the upper income brackets, where the differential is small. It follows that under reciprocal deductibility, an upward shift in the Federal rate structure results in greater absolute Federal subsidization in the lower income brackets and less absolute subsidization, expressed as an

effective rate on income, in the upper income brackets.[12]

Method of Accounting—Necessity for Simultaneous Solution

Implicit throughout this discussion of tax deductibility is the assumption that income tax liability to one jurisdiction and the income tax deduction claimed from the other jurisdiction are identical in amount. Any difference between tax deduction and tax liability implies that actual interstate tax differentials exceed those computed under simultaneous solution.

Since individual income tax accounting is largely on a cash basis, identity of tax deduction and tax liability would be assured only if individual incomes were constant over time or if both Federal and state income tax liabilities were collected currently as income is earned. In actuality individuals do move about in the size distribution of income from year to year and tax liability is not liquidated currently in full as income is earned. The result is that in case of extreme fluctuations in income the taxpayer lacks a sufficient amount of income tax deductions when he is computing tax liability for a year of high income and cannot fully absorb the deductions available to him in a year of low income. The combined tax liability of an individual taxpayer to both jurisdictions could, under cash accounting, well prove confiscatory during a period of rapidly rising income, if the sum of the nominal Federal and state rates were confiscatory. In any case, the combined tax liability under cash accounting would over a period of time tend to exceed substantially the amount computed by simultaneous solution.

Table 2 compares an individual's total tax liability under cash accounting and accrual accounting (simultaneous solution), over a period of five years. Both cash and accrual computations assume reciprocal deductibility.

Given even moderate variations in individual income, income tax deductibility fails to minimize interstate tax differentials when all income tax accounting is on a cash basis but income tax liability is not collected currently in full, because of graduation of the rate structure. If a person's income increases, his available deductions are small and he cannot take full advantage of the higher tax rates applicable to the upper income brackets. Conversely, when a person's income declines, his available deductions are large, but he must take them at the lower rates applicable to smaller incomes.

To insure identity of tax liability and tax deductions, it is necessary to account for the income tax deduction on an accrual basis. All other income tax transactions may be left on a cash payment basis. If, as a practical matter, it is not considered wise to depart from the cash payment concept, a simple alternative is available. The desired end may be closely approximated by

[12] That an upward shift in the Federal rate structure would produce these effects was anticipated by the State of Wisconsin. Before the 1941 Federal income tax rates became operative, Wisconsin enacted a limitation on the Federal tax deduction for State income tax purposes. Under the individual income tax, the maximum deduction was set at 3 per cent of net income. In the lower income brackets, $7,000 and under, where the degree of Federal subsidization increased, the limitation did not apply because the Federal tax was less than 3 per cent of net income. In the higher income brackets, however, the limitation introduced a large element of unilateral (Federal) deductibility, thereby avoiding a decline in the Federal subsidy which would otherwise have occurred.

differentiating the accounting time periods. While all other income tax transactions are accounted for on a calendar year basis, the income tax deduction might be accounted for on a fiscal year basis, ending March 15. By March 15, most of the tax liability on the previous calendar year's income is met, provided that computed refunds are treated as if repaid.

come taxpayer elects the standard Federal deduction.

Policy Implications

Under certain conditions, some of which already obtain in this country, independent Federal and state income taxes need not promote sizable tax differentials between residents of income-tax and non-income-tax states. Given

TABLE 2

COMBINED FEDERAL AND STATE INCOME TAX LIABILITY, EXPRESSED AS PER CENT OF INCOME, UNDER CASH AND ACCRUAL TREATMENT OF RECIPROCAL DEDUCTIBILITY FOR MARRIED RESIDENT OF MINNESOTA WITHOUT DEPENDENTS WHOSE INCOME FLUCTUATES FROM YEAR TO YEAR, AT 1948 RATES

Year	Net Income	Combined Liability			Difference Between Combined Liabilities		
		No Deductibility	Reciprocal Deductibility: Accrual Accounting[a]	Reciprocal Deductibility: Cash Accounting	Col. (3) — Col. (4)	Col. (3) — Col. (5)	Col. (5) — Col. (4)
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
1	$ 0[b]	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
2	100,000	55.7	48.2	55.7	7.5	0.0	7.5
3	1,000,000	86.9	77.4	85.7	9.5	1.2	8.3
4	100,000	55.7	48.2	0.0	7.5	55.7	—48.2
5	1,000,000	86.9	77.4	86.9	9.5	0.0	9.5
1-5	$2,200,000	84.1%	74.7%	81.0%	9.4%	3.1%	6.3%

[a] For tax liability; other items may be accounted for on cash basis.

[b] The first year's income is set at zero, in order to obtain a determinate amount of tax liability. The initial value chosen is of little significance.

The simultaneous solution of both tax liabilities with the deductions computed on an accrual basis presents no problems under unilateral deductibility. The same computations under reciprocal deductibility require the use of different tables of tax liability in the several states,[13] except when the low-in-

tax deductibility, preferably reciprocal; high and progressive Federal tax rates; fairly low state rates; and the identity of current tax liability to one jurisdiction with the deduction claimed from the other jurisdiction—given all these conditions—the interstate tax differential almost disappears, resulting in approximate uniformity in income tax burdens among residents of different states.

In the course of reducing interstate tax differentials, tax deductibility produces other consequences which appear

[13] The tables would be derived from these formulas:

$$(1)\quad F = \frac{RY(1-r)}{1-rR} + Fn - 1$$

$$(2)\quad S = \frac{rY(1-R)}{1-rR} + Sn - 1$$

The symbols are similar to those employed in footnote 4 but are not identical. R and r serve as the maximum bracket rates applicable to a given income. Y is the income in the bracket from which the tax deduction is to be taken. $Fn - 1$ and $Sn - 1$ represent cumulative tax liabilities up to the respective income brackets from which the tax deductions are to be taken. F and S are Federal and state tax liability, respectively.

to be not nearly so desirable. These have been stated as follows: (1) Tax deductibility subsidizes the states, at the expense of the Federal treasury. (2) Reciprocal tax deductibility introduces regressivity into the state income tax rate structures. Its principal advantage accrues to the wealthy. (3) In actuality, the tax deduction is granted on a paid, not an accrued, basis.

These criticisms are assessed below:

1. *Subsidization.* — The income tax deduction is akin to the personal exemption, which removes a portion of income from the measure of an individual's ability to pay taxes. Federal subsidization is a logically necessary, although incidental, consequence. The degree of subsidization depends on whether tax deductibility is unilateral or reciprocal. Some of the wealthy states have tended to disallow the deduction, deriving thereby a differential advantage. An enforced shift to reciprocal deductibility would undoubtedly cost them considerable revenues. A reaction on the part of the Federal Government towards no deductibility would, however, cost them even more. Superficially, the state tax rates would remain constant and their revenues unaffected. In fact, the Federal treasury's gain from the termination of its subsidy to state income taxes would be drawn from the pockets of the residents of these states. While unilateral Federal deductibility is more advantageous to the states than reciprocal deductibility, the latter is more advantageous than no deductibility at all.

It cannot be gainsaid that the scope of the existing Federal income tax seriously limits the revenues that the states can derive from this source. Unilateral (Federal) deductibility might therefore be viewed as a legitimate contribution by the Federal Government to the cause of progressive taxation in the states. For reasons stated below, the writer questions the importance of maintaining a progressive state income tax rate structure, viewed apart from the Federal rate structure. If the states need additional funds, they can raise their rates, graduate them more steeply, lower personal exemptions, or eliminate some of the advantageous tax treatment enjoyed by certain types of income. It is precisely the virtue of reciprocal deductibility that it permits both the Federal Government and the states to develop their respective income taxes with a relatively free hand.

This is not to say, however, that under existing circumstances an immediate campaign is indicated to condition the Federal grant of the deduction of the state income tax on a reciprocal state grant. In the absence of a comprehensive plan for income tax coordination (the elaboration of which exceeds the scope of this paper), such a campaign might readily backfire and enhance the existing confusion. Nevertheless, a comprehensive plan for coordination might do well to ask for reciprocal deductibility, in order to eliminate the revenue advantages nondeductibility states now enjoy over states granting deductibility.

2. *Regressivity in State Rate Structures.* — Under prevailing conditions, reciprocal deductibility introduces regressivity in the state rate structures. The exact point at which regressivity sets in depends on the height of the

income bracket to which progression in the nominal state rate structure extends. Most states end graduation in the neighborhood of an income of $10,000 and, with Federal deductibility, the effective state rate generally begins to decline at an income of about $100,000. If graduation in state rates were extended over a wider range of incomes, regressivity would set in at a higher income level. Ultimately, the effective state tax, expressed as a per cent of income, must decline, as the deduction for Federal tax liability increases in value and fails to be offset by increases in state tax rates.

It is doubtful that this separate view of the state rate structure is meaningful. Since both the Federal and state taxes are paid out of the same income, they might best be viewed jointly with respect to progressivity or regressivity. If the combined tax liability, expressed as a per cent of income, is too low (high), the individual rate structure can be raised (lowered). To view the tax structure as one whole seems conducive to more reasonable policy judgments.

3. *Accrued Tax Deductions.*—Tax deductibility is most effective in minimizing interstate tax differentials, when the tax deduction claimed from one jurisdiction coincides with the current tax liability to the other jurisdiction. Actual conditions do not quite fulfill this requirement, and correction is desirable. In view of the recent adoption of pay-as-you-go for the Federal income tax, only modest reform measures are indicated.

TREASURY TAX STUDIES, II *

CATHERINE RUGGLES GERRISH †

2. PERSONAL INCOME TAXATION

Exemptions

Individual Income Tax Exemptions [6] presents factual information on existing exemptions and their adequacy, matters of growing importance both because of statutory reductions and because of the rising cost of living. Alternative methods of adjusting exemptions are discussed from the standpoint of revenue, equity, economic effects, compliance, and administration. The problems of equity which are encountered in establishing any system of exemptions are reviewed. Consideration is given to the relative equity of exemptions for single persons, married couples, and dependents. Estimates of the relative amount of income necessary to yield the same standard of living among families of different size were made by the Bureau of Labor Statistics, using the two-person family as a standard. According to these estimates a single person needs 70 per cent of the income of a married couple for comparable welfare, and each dependent 24 per cent. Under the present law the exemption for both single persons and dependents is 50 per cent of that for a married couple. In other words, it would seem that the present system of exemptions allows relatively too little for single persons and relatively too much for dependents. The study notes the interesting point, however, that: "The contribution of a substantial amount of real income which usually is made by the housewife to the family is an important reason why the couple does not need twice the money income of a single person to attain the same standard of living. Since the income tax applies primarily to money incomes, the use of the above ratio to determine the relative amounts of exemption accorded single persons and married couples would seem to involve taxing the real income added by the housewife." (p. 18)

Little attention is given to the averaging of incomes and the problems related thereto inasmuch as they are to be developed more fully in a later Treasury study. Consideration is given to three methods of increasing the flexibility of the income tax so that it will yield more revenue in prosperity and less in depression and thus help check inflation or deflation: provision for the carryback of unused personal exemptions, which would permit filing for tax refunds by individuals whose incomes dropped below their exemptions; raising exemptions to combat slumps and decreasing them when inflation threatens; and varying rates in just the opposite way. In discussing the carryback of unused personal exemptions it is observed on the one hand "that this

* The first installment of this article appeared in the June, 1948, issue.

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[6] December, 1947. Pp. xii + 91.

kind of tax reduction would be equitable because it would single out for relief people whose needs were greatest, and at the same time put the money in the hands of those who would spend it promptly, thus helping to check the slump." (p. 27) On the other hand, it is noted: "Perhaps the strongest criticism of unused exemption carryovers is the great compliance and administrative difficulties, the potentially large revenue losses involved, and the fact that averaging would not be provided for higher-income taxpayers whose incomes never fall below their exemption allowances." (p. 28) In view of the importance of the matter and the fact that few Congressmen are experts on fiscal policy it would have been well to have discussed at greater length the argument on the one hand for putting money in the hands of those who would spend it promptly, and the relative importance, on the other hand, of potentially large revenue losses. With respect to the proposal to vary exemptions some Congressmen must have been amused upon reading: "Once exemptions were increased, it would tend to be difficult to lower them again as revenue needs increased." (p. 28) No one knows the pressure against lowering exemptions better than members of Congress, since they must answer for their actions at the polls, and yet when the need for more revenue has been imperative, exemptions have nevertheless been decreased.

This study also considers the relative merits of per capita and differential exemptions and discusses alternative adjustments in lieu of higher exemptions, such as the substitution of tax credits for exemptions, a low starting rate, and exempting income below a specified level. The major effects of substituting tax credits for exemptions might well have been discussed in more detail.

Family Income

The Tax Treatment of Family Income[7] is of less interest now that the law has been changed to allow married couples to split their income for tax purposes than when it was transmitted to Congress in 1947. Three other proposals are considered: mandatory joint returns, a dual-rate schedule, and a plan "to tax earned income to the earner and community-property income to the spouse exercising management and control." (p. 13) The discussion of the problem of the treatment of the income of minor children is of more than passing interest. In view of the attention given to this problem, it would have been helpful if quantitative information had been included to give some indication of its magnitude.

Earned Income

Tax Treatment of Earned Income[8] reviews the history of the credit for earned income, appraises the arguments therefor, and proposes two methods for granting such a credit. One method would grant a credit of 2 per cent of earned adjusted gross income against a tentative tax computed without such a credit, and the other would allow a 10 per cent deduction of earned adjusted gross income in computing final tax liability. The two methods do not

[7] June, 1947. Pp. v+42. Reprinted in *Revenue Revisions, 1947-48*, Hearings before the Committee on Ways and Means, House of Representatives, 80th Cong., 1st Sess. [cited hereafter as *Hearings*], pp. 844-874.

[8] November, 1947. Pp. ix + 43. *Hearings*, pp. 3974-4000.

differ greatly in their equity and revenue effects, but the latter would be somewhat preferable from the point of view of improving incentives to work and invest, since it would give somewhat greater relief to higher income groups. Consideration is also given to an earned income credit as against alternative methods of reducing taxes, with the conclusion that a general rate reduction would probably be more flexible, and insofar as it might give more relief to high income taxpayers, would be more effective in stimulating incentives to work and to invest.

Although this study follows the general pattern of making no recommendations, it is obvious that the Treasury does not favor an earned income credit in principle. To the argument that the recipient of earned income is not allowed any deduction for depreciation although his productive facilities depreciate as he gets older and are ultimately exhausted, and that therefore he needs a differential tax advantage to save for his old age, the study replies that continuation and perfection of the social insurance system is preferable to an earned income credit. A device for averaging all income, earned and unearned, is seen as preferable to an earned income credit as a way of meeting the problem that persons who earn high salaries during a short working life are not allowed averaging of income extended to recipients of capital gains or business income. Whether an earned income credit would have a favorable effect on investment is uncertain. The question is raised as to whether the incentive to invest is not as sensitive to high taxes as the incentive to work and it is observed: "There appear to be no good grounds for regarding investment as performing a less useful part than personal service in the productive process. . . . The active investor who directs his own capital now into one and then into another venture may be contributing as valuable personal services as the hired manager, and yet most of his income would not ordinarily be counted as earned." (p. vii) However, the study does not recognize that the question whether investment is more or less useful than personal services is irrelevant to the question of the sensitivity of investment to high personal income tax rates. Nor is account taken of the fact that the bulk of investment expenditures is made by corporations and so is not greatly influenced by the personal income tax. Personal services, on the other hand, may be withheld from the market completely if the net remuneration is inadequate compensation for exertion.

Pensions and Annuities

The Income Tax Treatment of Pensions and Annuities [9] discusses the problems and inadequacies of the present law and presents some alternative solutions. The basic problem is to separate the part of the annuity receipt which is repayment of capital from the part which is interest earned on the investment. Under the present law, the "3 per cent rule," an amount equal to 3 per cent of the cost of the annuity is included as income every year until the cumulated balance of annual payments equals the amount paid for the annuity, and thereafter all payments are included in income. Among the defects of the present law are inadequate allowance for the return of principle in some cases, distortion of income over a period of

[9] December, 1947. Pp. vi + 49, App. *Hearings*, pp. 4001-4051.

years by "bunching" the "tax-free recovery of capital in a few early years" (p. 15), instead of spreading it over a longer period, lack of an appropriate adjustment for those who die before recovering capital tax-free, computation and cumulative record-keeping necessitated by the fact that the amount of annuity receipts which must be included in taxable income changes as capital is recovered tax-free.

Three alternative solutions are proposed. The first would change the 3 per cent rule and separate the income and capital elements so as "to include in taxable income a portion of each annuity payment equal to the average annual income element under such a contract as determined on an average life expectancy basis." (p. 29) Annuitants who do not live their life-expectancies would not be allowed an adjustment for mortality losses, and annuitants who outlive their life-expectancies would not be fully taxed. In other words, it would provide equitable tax treatment to annuitants as a group. The second plan would modify the 3 per cent rule by providing more adequately for capital recovery. The amount required to be included in income would be reduced from 3 per cent to some lower percentage, such as 1 or 1.5, while the taxpayer would be given the option of including a larger amount. Various proposals are discussed for allowing in one way or another for the deduction of losses incurred by short-lived annuitants. A third plan, the reserve-earnings approach, would include in the taxable income of the annuitant each year "an amount equal to the interest earned on the reserve remaining in the annuity." (p. 28)

Under the present law certain pensions and annuities are exempt from taxation. Social security, old age and survivors insurance benefits, and pensions paid under the Railroad Retirement Act are two large groups of payments that are exempt. As yet the revenue losses from the exemption of these annuities is small, but it will tend to increase with the maturity of the social security and railroad retirement programs. Compensation for injuries or sickness and disability retirement pay are exempt as well as pensions which are gratuities. The Treasury points out that these exclusions discriminate not only against other groups of annuitants but against taxpayers in general. It has previously recommended that social security and railroad retirement benefits be included in income subject to the general revenue laws. The study takes note of, but does not evaluate, the view "sometimes urged that a case for the exemption of disability payments cannot be made unless similar exemption is granted all disabled persons regardless of the source of income." (p. 19) Mention is also made of proposals to provide special exemption for handicapped persons similar to the $500 deduction for the blind.

Another inequity in the present law is the treatment of life insurance proceeds payable by reason of death of the insured, which are entirely exempt whether paid in a lump sum or in installments, including the element of interest earned after the death of the insured. The result is "the exclusion from taxable income of a larger aggregate amount than the lump sum payable at the time of death of the insured." (p. 25) The current state of affairs seems to be due to the fact that the law is not very explicit and that the courts have not upheld the regulations which have

provided for treating installment payments as partly capital and partly interest.

The treatment of employer and employee contributions under retirement plans presents a difficult problem for which there appears to be no ready solution. Since employer contributions under qualified plans are not taxed to the employee, "the employee whose employer pays a lower nominal wage and supplements it with retirement benefits appears to have a tax advantage over another employee in the same substantive position who receives a higher money wage subject to larger deductions for retirement." (pp. 24-5) Consequently, "existing provisions have tended to encourage non-contributory as against contributory plans and, under contributory plans, a higher ratio of employer to employee contributions." (p. 25) In fact, "It is estimated that roughly two-thirds of the qualified industrial retirement pension plans are noncontributory." (p. 25) One solution would be "to include employer contributions in employee's income for tax purposes" (p. 47), and another would be to deduct from income all employee contributions to pension plans and to include benefits to their full amount in gross income when received. The latter plan obviously "would tend to call for similar tax treatment of other savings items" and a "basic change in the annual taxable income concept." (p. 48)

3. ESTATE AND GIFT TAXES

Federal Estate and Gift Taxes,[10] the most ambitious and the most finished study of the group, is a joint study by the Treasury and the Advisory Committee on Estate and Gift Taxation. The Committee was composed of five attorneys, specialists "in Federal tax practice, particularly with respect to transfers in trust and similar family dispositions," who were invited by the Treasury in 1944 to cooperate in a study of these problems. (p. 1) It is to be hoped that the recommendations made in this study will be a matter of legislation soon. "Such legislation is not recommended as a series of piecemeal suggestions dealing with unrelated matters. . . the proposals which have been agreed upon are necessarily interdependent upon each other and make up a single plan rather than a group of isolated proposals. In view of this interdependence, no one feature of the suggested plan is recommended separately from any other and none should be so considered." (p. 3)

The study is made up of four parts, the first of which is concerned with an appraisal of the present system. No consideration is given to the level of tax rates, exemptions, or annual exclusions, since the report is concerned with "legal principles of incidence" rather than "specific revenue goals." The second part consists of proposed revisions. Legislation is recommended in detail and a draft of the proposed statute is included in an appendix. The third part includes a discussion of the principle matters at issue, and the fourth part applies the legislation found to be most desirable to hypothetical cases. For the use of both Congressional and other readers, a glossary of terms would have been helpful.

Under the present law the tax burden differs between transfers made during life and those made at death. "This dual system conflicts with the ideal of substantial equality of burden as measured by a substantial equality of ability

10 1947. Pp. 178. *Hearings*, pp. 3798-3973.

to pay tax. For example, transfer tax consequences may vary appreciably, depending upon when and how a disposition is made. The individual who postpones disposition of his property until death may not only incur higher estate taxes but also may bear a larger income-tax burden. Disparity in burden might conceivably be justified if each transferor were in a position to choose his method of disposition. But the necessity for liquidation at a sacrifice of part of his estate in order to obtain cash to pay the tax on an *inter vivos* transfer may deter a potential donor. Frequently the privilege of making dispositions during life fails to materialize because death intervenes before the taxpayer is able to act. Thus freedom of choice is not equally operative in all instances." (pp. 7-8) Transfers during life are less expensive from the point of view of taxes because the gift tax rates are lower than those of the estate tax, because breaking property up into two or more lots results in its being taxed in lower brackets than if it were all transferred at one time, because the gift tax allows for additional exemptions, and because the estate tax is assessed on the whole of the estate including the part which must be paid in taxes while the gift tax is assessed only on the amount which is transferred. Not only are there these differences in the treatment of transfers during life and at death, but the situation is further complicated by the contemplation of death statute.

Moreover, at the present time the concept of what constitutes a complete or an incomplete transfer is different under the estate, gift, and income taxes. An individual may transfer part of his income to a member of his family through an *inter vivos* gift, thus bringing part of it into a lower income tax bracket, and yet at the same time his control over the property may be practically undiminished. Or by transferring property an individual may free himself from income taxes thereon, and yet be liable for estate taxes on the same property. Or he might free himself from estate tax liability but be required to pay income taxes. This situation would be remedied by the recommendations of the study which are very specific in regard to what should constitute a complete transfer.

The objective of the study was to find an equitable method of taxing transfers of property, whether made *inter vivos* or at death, and a correlated method of taxing income from such property. Accordingly, the participants in the study recommend "That the present estate and gift taxes be integrated into a single transfer tax." (p. 14) Upon the death of a taxpayer the transfer tax would be computed on the entire estate, including both transfers during life or at death, and from this amount would be subtracted the amount of taxes previously paid on *inter vivos* transfers. The difference would be the tax payable on the estate. "Except for the fact that lifetime transfers would reduce the estate at death by the amount of the transfer tax paid, the total transfer-tax burden would be approximately the same whether or not the transfers were made during life or were concentrated at death." (p. 14) A single rate structure is recommended and "a single exemption which the transferor could exhaust as he saw fit," (p. 15) although "a small exclusion on a per donee basis might still be desirable." (p. 17)

As for the income tax, it is recommended that the transferor of property should still be liable for it " until he has relinquished sufficient controls or contacts to render the transfer complete under the proposed transfer tax." (p. 17) When the transfer is complete, and not before, the transferor becomes subject to the transfer tax, and from that time on his liability for the income tax ceases. Since in the case of an incomplete transfer a grantor might be inconvenienced by lack of funds to pay income taxes on the trust, it is recommended that he should have " a right to recapture from the trustee a proportionate part of the trust income which is taxable to the grantor." (p. 17)

The study makes no recommendations concerning the problem of administrative and managerial powers and their relation to trusts " because of the participants' belief and expectation that general recognition will be given to the desirability of incorporating the principle of the unity of family income into the tax law as rapidly as possible " (p. 42), an expectation that has been realized in large part.

4. SOCIAL SECURITY COVERAGE

The Extension of Old-Age and Survivors Insurance to Agricultural and Domestic Service Workers and to Self-Employed Persons[11] discusses the feasibility of extending the scope of the present system. Although many of the administrative problems are still found to be perplexing, " administrative considerations no longer constitute an important barrier to the expansion of coverage." (p. 1) The difficulty in using the income tax mechanism to collect taxes from the self-employed is not nearly so serious now that exemptions are lower as it was in 1935, although the problem of how to separate " that part of income attributable to personal services from the balance due to capital investment " still exists. (p. 2) The problem of collecting social security taxes and adequate wage reports from farmers and housewives has been lessened by the effect of farm aid programs and rationing in " making the population record conscious." (p. 4) The matter of the valuation and taxation of income received in kind would be somewhat troublesome, even as it now is for the groups already covered in the system. But " The extent to which complete coverage can be approached is limited only by the Government's readiness to undertake the administrative burdens involved." (p. 20) Any system of voluntary coverage is precluded by the " prospective dependence of the system upon financing from the general fund," since it would mean that " the general fund would tend to subsidize social insurance protection for the benefit of a select group of individuals who need it less than some of those not covered," and since it would also " tend to involve an adverse selection of risk." (p. 5)

The plan for extending coverage to the self-employed would require such persons " to file social security tax returns covering their self-employment income and to pay the tax directly to the collectors of internal revenue, very much as taxpayers now file income tax returns." (p. 20) Insofar as possible provision would be made for segregating wage or earned income from other income.

[11] December, 1947. Pp. 45.

Three plans are proposed for extending the coverage of the system to agricultural and domestic workers. A choice among them "will need to be made on the basis of several criteria, and in the light of a delicate balancing of the technical administrative considerations on the one hand and the desired coverage on the other." (p. 10) One plan would rely entirely on an extension of the present system. The other two plans would supplement the present system with the use of stamps or of wage books with stubs and detachable slips. These three plans are compared in detail in an appendix as to their administration, the employers' burden, the employees' burden, enforcement, taxpayer resistance and inertia, and correction of underpayments or overpayments.

5. EXCISES

Federal Excise Taxes on Tobacco,[11a] *Federal Retail Excise Taxes,*[12] *Excise Taxes on Communications,*[13] and *Federal Excise Taxes on Transportation*[14] all follow a similar pattern. In each case the history of the tax is reviewed and the economic background of the industry is considered. Some estimate is made of the effects of each tax on profits, on competition within the industry, and on consumers. Finally technical and administrative problems are discussed.

The Treasury seem to favor the proposal for taxing economy brands and standard brands of cigarettes at different rates. The present "flat tax on physical volume represents a different percentage of manufacturers' selling prices for cigarettes in different classes." (p. 2) Such a change "would enable lower income consumers to purchase economy brands with a smaller total expenditure and the amount of tax involved would represent a lower proportion of their income." (pp. 24-5) It is suggested that the seven brackets under which cigars are taxed be brought "into better alignment with present price relationships of cigars." (p. 51) The Treasury is opposed to the suggestion that the tax on toilet preparations be imposed again at the manufacturers' level as it was before 1941. The suggestion stems from the compliance burden on drug stores, but the earlier method involved "serious inequities and administrative difficulties." (p. 69)

The conclusions drawn as to the effect of transportation taxes on business are open to serious doubt. It is held that, "Since transportation costs generally are small in relation to the total costs of business, it would appear that the use of transportation would depend more upon changes in other costs than in the price of transportation." (p. 34) Although it is observed in this connection that "Important exceptions exist where transportation constitutes a large percentage of total cost of a product," (p. 34) when the effects of the tax on the profits of the transportation industry are discussed it is maintained that, "in view of the probable unresponsiveness of the demand for freight transportation to changes in the cost of such transportation and the relatively low rate of the present tax, it is doubtful whether the profits of the industry would be affected very substantially by

[11a] February, 1948. Pp. 76.

[12] October, 1947. Pp. iv + 69. *Hearings*, pp. 3707-3738.

[13] July, 1947. Pp. iii + 37. *Hearings*, pp. 637-656.

[14] December, 1947. Pp. ii + 43.

the tax." (p. 35) Is one to conclude that the authors of this study believe that transportation cost is of practically no importance to the location of industry, and that the protracted discussion as to whether the general economic development of the South has been retarded by our schedule of freight rates is all beside the point? Data are presented for 1941 showing the percentage of freight revenue to the value of selected commodities at destination and the effective rate of the transportation tax on the value of these commodities. The percentage of freight revenue to the value of commodities varies from 3.71 percent to 64.06 per cent and the effective rate of the tax from 0.11 per cent to 1.83 per cent. The effect of a change in the transportation tax would obviously have a considerably different effect on those industries in which the effective rate of tax to value of commodities was under 0.5 per cent from what it would have on those industries in which the latter was over 1.5 per cent. Furthermore, no consideration is given to the profit margin under which different industries operate.

The question whether taxes on all business should be as nearly uniform as possible, which has appeared numerous times in these studies, recurs here. As already noted, a lower rate of tax for economy cigarette brands than for standard ones is favored on the grounds of equity for consumers, although it might very likely affect the manufacturer of these two kinds of cigarettes differently. In the discussion of taxes on long distance communication services, uniform tax rates are favored because "Differential rates give rise to competitive advantages for the services taxed at lower rates" and "might cause important shifts in demand." (p. 14) Furthermore, "Other business users that do not have such freedom of choice would be treated inequitably if the service required by them were taxed at a higher rate." (p. 14) There is some lurking doubt in the authors' minds, however, about uniformity of treatment as shown by the statement: "Lower tax rates for telegraph than telephone would help to improve the position of the carrier and maintain this form of communication, but would raise the question of whether such a policy should be followed in the treatment of competing services." (p. 15)

6. FEDERAL-STATE TAX COORDINATION

Federal - State Tax Coordination[15] supplements the 1942 report of the special committee on Federal, state, and local government fiscal relations. "Subsequent developments, largely through the impact of the war, have modified some of the problems in the field of Federal-State fiscal relations, particularly with respect to a number of the taxes, and have also served to enlarge the scope of administrative cooperation between the several governments." This study discusses these developments, provides "a tabular presentation of the current situation with respect to the principal taxes involved in Federal-State tax relations, and indicates the subjects considered to have most promise in connection with the formulation of a practicable near-term coordination program." (p. 1) During 1946 more than 90 per cent of all taxes collected by the Federal and by state governments came from the same sources, i.e., taxation of income, death

[15] August, 1947. Pp. 31. *Hearings*, pp. 3676-3706.

and gift transfers, liquor, tobacco, gasoline, stock transfer, and miscellaneous sales.

Although twenty-nine states and the District of Columbia impose individual net income taxes, the higher exemptions allowed under state laws result in many taxpayers being subject to the Federal tax only. The discussion of mutual deductibility of Federal and state income taxes in computing taxable net income is somewhat confusing. The Federal law allows state income taxes to be deducted in computing net income for income tax purposes, and about two-thirds of the states imposing income taxes allow a similar deduction of the Federal tax in computing state income taxes. The provision for such deductions reduces " the overall burden on taxpayers residing in income tax States " and " has the further effect of minimizing interstate differentials in tax burdens." (p. 4) It is found that " the combined effective rate of the Federal and State income taxes, especially in the higher income brackets, is not appreciably affected by the existence or non-existence of a State tax." (p. 4) Nevertheless it is claimed that " mutual deductibility is an effective coordinating device particularly at the higher income levels, where a confiscatory rate might result from the combination of Federal and State taxes," (p. 4) and it is noted that, " This fact notwithstanding only one State . . . has recently adopted a deductibility provision." (p. 5)

Although there is considerable similarity in the definition of personal and corporate tax bases by the Federal and state governments, much more coordination may be achieved in this direction. " Uniform definition of the tax base and the use of common tax returns would open the way to Federal-State agreements for unified administration of the two taxes which would be practicable even if it were limited to only some of the States while others continued their present independent policy." (p. 6)

Some degree of coordination has been achieved in recent years through Federal-state and interstate cooperation. States now have the privilege of inspecting Federal tax returns and on payment of a fee may obtain copies of Federal returns. Information on readjustments of Federal taxes are also available through " special transcript services provided by the Bureau of Internal Revenue to the States at nominal expense." (p. 7) Furthermore, there is " some informal cooperation between the administrative staffs " of the state and Federal governments, and some exchange of information between states. The Federal Government for its part is aided by the state governments withholding Federal income taxes from salaries and wages paid by state and local governments.

The form of state death taxes varies widely, and the rates of most of them exceed the 80 per cent credit established under the 1926 law. Changes in the Federal law have operated to decrease the proportion of estate taxes collected which are due the states under the credit provision from 76 per cent in 1931 to 10 per cent in 1944. It has been proposed that a new crediting device be adopted based on the current Federal estate tax in order to increase revenue, promote coordination, and help solve jurisdictional disputes. Reference is made to the report, *Federal Estate and Gift Taxes*, and the hope is expressed

that it will " open up avenues of administrative cooperation." (p. 14) Although no credit is allowed the states under the Federal gift tax, in most of the twelve states which have gift taxes the rates are the same as for death taxes. However, " To the extent that the lower rates under the [Federal] gift tax encourage the distribution of estates during the lifetime of the owners, the amount of the estate subject to State taxes and the amount of State revenue is reduced." (p. 13)

Tobacco taxes are an " example of extreme overlapping." (p. 15) Although such taxes are relatively much more important for the Federal Government, state taxation of tobacco, a relatively new development, has grown rapidly in recent years. Eight states added such taxes in 1947, bringing the total to thirty-eight states. State tobacco taxes, which are largely cigarette taxes, present serious administrative problems in spite of interstate cooperation, because of " lack of control over interstate shipments," and because they are mostly collected from wholesalers, unlike the Federal tax which is collected from manufacturers. " The problem . . . is not so much one of overlapping Federal-State taxation, as the inability of the States to efficiently administer their own taxes with respect to interstate shipments." (p. 18) Various proposals have been made for doing away with state taxes and distributing a portion of the revenue from the Federal tobacco taxes to the states. However, " In the immediate future, the scope of coordination will probably be limited to such administrative cooperative measures as the States are able to develop with one another." (p. 18)

As for other taxes the study finds that both the Federal and state governments use amusement and stock transfer taxes without many difficulties arising. In the case of liquor taxes there seems little prospect for coordination other than through administrative cooperation in view of the fact that these taxes are closely related to the regulation of liquor which is a state matter. Although dual taxation of gasoline has no very serious consequences, the study believes there is something to be said for the proposal that the Federal Government, which entered this field later than the states, withdraw in return for state withdrawal from some other field. In the case of state general sales taxes and Federal miscellaneous manufacturers' and retailers' excises " duplication . . . is of secondary importance in comparison with the economic impact of the Federal excises," but " the existence of the duplication will probably be one of the factors considered in connection with the re-examination of the Federal excise structure which the Congress is expected to undertake in connection with postwar tax revision." (p. 31)

* * *

In addition to the studies here reviewed, the Treasury has announced that studies are in preparation on the following subjects: capital gains and losses; allowance for life insurance and other forms of savings; averaging of individual incomes for tax purposes; depreciation; exempt corporations, other than farm cooperative associations; American corporations doing business abroad; excise tax discrimination between imported and domestic goods; and excise taxes on household appliances, amusements, automobiles and equipment, electrical energy, and miscellaneous commodities and services. Since this article was written, *Federal Excise Taxes on Alcoholic Beverages* (July, 1948. Pp. 101) has been released. [Editor's note]

INVESTIGATION OF THE BUREAU OF INTERNAL REVENUE

A SPECIAL advisory group appointed by the Joint Committee on Internal Revenue Taxation has carried out an investigation of the organization, staffing, and work of the Bureau of Internal Revenue and has submitted a valuable report to the Congressional Committee.[1] The advisory group found: " the enforcement activities of the Bureau of Internal Revenue are inadequate to cope with the responsibilities of equitable tax administration. The enforcement staff is too small; it is in part underpaid, in part undertrained, and in part ineffectively directed." (p. v) In the opinion of the advisory group, standards of integrity in the Bureau and morale are very high, but changes in organization, procedures, and staffing are needed to attain proper enforcement and efficiency.

Attainment and maintenance of desirable standards will be costly, the advisory group warns, but the alternative of cheap tax administration " costs, in the long run, more than any nation can bear." (p. vii) It is estimated that a staff of about 68 thousand would be required " adequately to administer present tax laws with substantially the present type of Bureau administration," as compared with an average of about 57 thousand actually employed during the fiscal year 1947. (p. 7) Appropriations of $250 million are described as " the cost of providing personnel and facilities that are needed now and should be procured with the greatest possible dispatch "—but not the estimated cost of operating the Bureau at peak levels of efficiency with suitable standards of enforcement. (p. 8) Actual appropriations for the fiscal year 1948 were $188 million.[2]

The special advisory group consisted of: Henry H. Bond, attorney, New York; William J. Carter, C.P.A., Atlanta; N. Loyall McLaren, C.P.A., San Francisco; and George W. Mitchell, tax economist, Federal Reserve Bank, Chicago. Simultaneously with its report, the Joint Committee released statements by the Treasury Department and the Commissioner of Internal Revenue setting forth the views of the enforcement agencies.

The following pages contain a summary of the report and of the statements of Treasury and Bureau officials.

REPORT OF THE ADVISORY GROUP

The Bureau and the Federal Tax System

The nature and volume of work of the Bureau of Internal Revenue are determined mainly by the character of

[1] *Investigation of the Bureau of Internal Revenue.* Report to the Joint Committee on Internal Revenue Taxation, pursuant to sec. 1203 (b) (6), Revenue Act of 1926, by the advisory group appointed pursuant to Public Law 147, 80th Congress. Washington: Government Printing Office, 1948. Pp. vii + 58. The letter of transmittal is dated January 27, 1948, but the report was not publicly released until April 23, 1948. See also statements to the Joint Committee by the Treasury Department and Commissioner of Internal Revenue with respect to the report. Washington: Government Printing Office, 1948. Pp. 18.

[2] Statement of Treasury Department, *op. cit.*, p. 2.

the tax system. The area of administrative discretion open to the agency is rather closely defined by statutes and judicial decisions. There is no one satisfactory measure of the workload, owing to differences in taxes and appropriate administrative and enforcement methods and to changes in tax rates. Factors determining the amount of work to be done include the number of types of taxes, tax rates, number of taxpayers, amount of gross revenue collections, nature and size of the tax bases, nature and proper intensity of enforcement activities, amount of work entailed by claims and adjustments, prominence of regulation as an objective of taxation, and the statutory division of essential record keeping among the Bureau, taxpayers, and intermediaries.

Percentage Increase in Federal Tax Yields, Number of Accounts, and Number of Returns Between 1940 and 1947

Tax	Net Yield	Tax Accounts	Tax Returns
Individual income	1,738	602 [a]	773 [b]
Estate and gift	119	50	50
Corporation income	530 [c]	— 1 [d]	— 1 [d]
Liquor	300	— 16 [d]	[e]
Tobacco	102	— 24 [d]	[e]
Employment	143	31	31
Excise, occupation, and other miscellaneous	441	136	511
All taxes	579	405	381

[a] Does not include declarations of estimated tax.

[b] Includes declarations of estimated tax.

[c] Based on receipts in calendar years 1940 and 1947.

[d] Decrease.

[e] Administration of tax does not involve filing of returns by taxpayer.

During the war, there was a vast expansion in the workload of the Bureau. Three measures of the extent of this expansion in each of the principal types of taxes between 1940 and 1947 are presented in the accompanying table. In addition to returns, the Bureau handled some 162 million supplemental documents in 1947. The most spectacular wartime change was in the individual income tax, reflecting reduction in exemptions, increase in rates, and adoption of withholding. Other taxes were increased in rates, and new excises were imposed. This expansion came at a time when qualified personnel, mechanical equipment, and space were difficult or impossible to obtain. The Bureau is still using prewar procedures not suitable for its present scale of operations. Much greater mechanization is required for efficient handling of the present volume of work.

The report contains a chart showing the estimated man-hours expended in the fiscal year ended June 30, 1947, in the administration of the major types of taxes by detailed operations. (pp. 49-58) This is the most recent analysis of this kind showing the relative manpower required for administering the various forms of taxes. The following summary has been prepared from the chart. In the fiscal year 1947, the percentage of total Bureau man-hours devoted to the major classes of taxes was as follows:

Individual income tax	62.6
Corporation income and profits taxes	9.3
Employment taxes	6.6
Estate and gift taxes	1.4
Miscellaneous taxes	5.2
Alcohol tax	8.8
Activities and operations not allocable	6.1

Between 1940 and 1947, Bureau personnel (authorized positions) increased from 22,800 to 57,900, or 150 per cent; its expenditures rose from $60 million to $204 million, or 240 per cent.

As of December 31, 1947, over 56 per cent of investigative and technical employees were in the base pay range of $3,400. The advisory group states: "At this level it is virtually impossible to obtain the abilities and backgrounds required to administer the present-day tax system. Some upgrading of the position now occupied by the deputy collectors, and the utilization of the additional capabilities thus acquired, appears to be called for." (p.16) Figures on the age distribution of employees show that in Washington more than 38 per cent of the entire staff is over fifty years of age; about 55 per cent of the technical and investigative employees are over fifty and have twenty years or more of service. In some sections of the Bureau, a very large proportion of the staff will reach the retirement age within a few years.

Although differences in tax systems and other institutions make comparisons of administrative costs of doubtful significance, it is interesting to note that the Department of Inland Revenue in Great Britain employs about the same number of persons as the Bureau of Internal Revenue, although it deals with only about one-third as many taxpayers and collects only about one-fourth as much revenue. The cost of the British agency is about two-thirds of 1 per cent of the yield; of the United States agency, about one-half of 1 per cent. The Canadian Department of National Revenue has less than one-fourth as many employees as the Bureau and collects only about 6 per cent as much revenue. The operating costs of the Canadian agency are nine-tenths of 1 per cent of collections. Scanty data indicate that American states and localities combined spend somewhat more than the Bureau on tax administration but collect only about one-fourth the Federal revenue.

Requirements for Proper Enforcement

The idea sometimes advanced that tax enforcement is not necessary in a democracy is not supported by experience. Even if there were no deliberate attempts at evasion, the complexity of Federal taxes would still require review and investigation of tax returns to make sure that liabilities were correctly determined. Moreover: "from a purely business standpoint the returns from enforcement expenditures are fabulous. A yield of at least 100 per cent on every dollar's worth of additional investigational effort would now be realized in nearly any such phase of Bureau activity. In many areas yields will run from 1,000 to 2,000 per cent." (p.21) Indirect gains would exceed these direct returns. Effective enforcement helps in absorbing purchasing power to combat inflation. But the most compelling reason for high enforcement standards is that they are necessary to achieve uniform and equitable taxation. "Non-enforcement is a tacit classification of taxpayers into different rate brackets than contemplated by the law." (p.21) Under the withholding system it is almost impossible to evade taxes on wage and salary income, but enforcement and audit are required to ensure equally full collection from business, farm, and professional income. Prevention of evasion by the dishonest minority is necessary to assure continued voluntary compliance by the honest majority.

In the long run, the most economical enforcement program is one that

"maximizes the likelihood that the original tax return is completely and correctly filled out." (p. 22) This is the practical justification for a vastly expanded program of assistance to taxpayers in filing returns. An effective program would require additional personnel and some lengthening of the period for filing returns and some scheduling of taxpayers to even out peak loads.

Fuller taxpayer cooperation depends on mutual confidence. Congress, administrative officials, and the courts should attempt to foster such confidence by removal of unfair discrimination among taxpayers. Administrative officials must convince taxpayers that they are equally concerned with protection of the revenues and of the interests of taxpayers. The assumption that the taxpayer can look after his own interests and the Bureau need only look after the Government's interests must be discarded. "The entire tone and atmosphere of the enforcement procedure need to be reconditioned—the point of view of many in the enforcement staff reoriented." (p. 23)

A staff agency of the Commissioner should devote a major part of its resources to the development of objective measures of the adequacy of enforcement of various taxes in different areas and the results of different types of enforcement activities. These studies would attempt to estimate the ratio of collections in a district to undiscovered additional liabilities and to overassessments. They would offer the Bureau a guide to apportionment of its resources.

The present audit program is designed to produce maximum additional assessments with available manpower and may well be successful in this objective. Emphasis is centered on returns which promise to yield the greatest additional assessments. Returns of low-income taxpayers, which individually involve small liabilities but which bulk large in the aggregate, are seldom examined. In the fiscal year 1947, 2¼ million income tax returns were examined, and a change in liability resulted in more than one-half the cases. Additional assessments of nearly $750 million were made.

Under the present program, less than 1 per cent of persons filing taxable assessable Form W-2 returns are subjected to audit, and most taxpayers filing such returns are not likely to be audited even once during their lifetime. On the other hand, returns showing large incomes, large refunds, or a large number of dependents are almost certain to be audited. Similar differences in frequency of audit exist in the case of Form 1040 returns. The small number of returns audited and the methods of selection of returns for audit "practically guarantee immunity from investigation for large segments of the taxpaying population." (p. 26)

Three methods are available for selection of returns for audit: (1) regular cycle for predetermined classes; (2) judgment of qualified persons who screen returns; (3) random sampling. The first method is used for very large taxpayers; the second method is extensively used. The Bureau does not use random sampling.

All three methods of selection should be used. Approximately 2 million of

the largest returns should be examined on a one- or two-year cycle. All returns reporting income from business, farming, or professions should be examined on a two- to three-year cycle. Other classes of returns should be sampled in such a way as to secure reliable measures of misreporting. In this examination all information returns should be matched with the audited returns. Controls should be established to assure the adequacy of the program.

Requirements for Efficient Operation

The Bureau is composed of a number of more or less autonomous units, each headed by a deputy commissioner. This type of organization makes administrative planning and allocation of resources difficult. The Office of the Chief Counsel is legally a part of the Office of the General Counsel of the Treasury. This anomolous situation should be corrected.

Most of those in executive positions, except for the collectors, have come up through the ranks within the Bureau. Experience and the Bureau's training program assure competence in technical tax matters but not necessarily in administrative management.

A major management problem is the division of responsibility between Washington and the field and the control of decentralized field activities. The field organization is at present not integrated, which results in duplication and confusion of authority.

The Commissioner has a large staff to advise and assist him on matters of tax law, but he lacks comparable facilities with respect to administration and management.

Specific Suggestions for Improvement in Bureau Management

A number, but not all, of the advisory group's specific suggestions for improvement of Bureau management are summarized below.

Staff Agency for the Commissioner.—Top priority should be given to establishment of a qualified staff agency under the Commissioner to make continuing studies of the Bureau's operating and enforcement problems. The Commissioner should have authority to employ private management organizations for specific surveys and to draw on professional advice outside the Bureau.

Reorganization of Field Offices.—The field offices, which now include eight separate organizations, each reporting to a central staff in Washington, should be reorganized. Except for the offices of the alcohol tax supervisors and the personnel investigation of the intelligence agents, the field work of the Bureau should be carried on by two organizations—the collectors' offices and the agents' offices. The collector would receive voluntary returns, process remittances, handle accounts of individual taxpayers, and maintain records and files of all tax accounts in his district. His enforcement staff would spend four to six months of the year assisting taxpayers in the preparation of returns and the balance of the year in locating delinquent taxpayers, enforcing collection where liability had been determined, and verifying returns. The agent's office would include the technical personnel needed to examine accounting records of taxpayers with respect to income, estate and gift, payroll, and certain excise taxes. It would

include the Technical Staff conferees, special agents engaged in joint investigation with revenue agents, miscellaneous tax special agents, and representatives of the Chief Council in the Appeal and Penal Divisions. This organization would enable the agent to manage enforcement activities intelligently and allocate personnel to the most urgent tasks.

Reorganization of Washington Office.—With the reorganization of the field offices, the Washington office would be transformed into a supervisory and management unit. The grouping of all enforcement personnel in the offices of the agents in charge would transfer the duties now performed by the Technical Staff to the Income Tax Unit and reduce the responsibility of the Intelligence Unit in Washington. The recommended abandonment of classification of tax returns into Bureau returns, and collectors' returns, together with increased responsibilities for excise tax enforcement in the field, would result in reduction of the size of the Miscellaneous Tax, Employment Tax, and Income Tax Units in Washington. The Employment Tax Unit and the Miscellaneous Tax Unit should be combined into a Wage and Excise Tax Unit. This unit would discharge the functions now performed by the rules and regulation sections of the present units and would administer tobacco, oleomargarine, narcotics, and certain other excises involving a comparatively small number of taxpayers and presenting difficult technical problems. The recommended reorganization would make it unnecessary for employment tax returns or other miscellaneous excise tax returns to be sent to Washington for processing or verification. Except for legal interpretation and drafting of regulations, the entire administration of these taxes would be in the field. These reorganizations would reduce the Washington personnel and increase field personnel, but it is believed that a net saving would be possible.

Taxpayer Relations.—Much progress has been made in simplification of tax returns, but in the case of Form W-2 the movement may have gone too far. Addition of a few questions to this form would greatly aid in administration, without significant loss of simplicity. Similarly, more comprehensive annual returns might be substituted for the present sketchy quarterly and monthly returns for wage and excise taxes. The instruction sheet for Form 1040 could be further simplified. An authoritative pamphlet on the individual income tax could be prepared and sold at cost. In addition to these steps, the filing period for individual returns could be extended to six months and technical personnel made available to assist taxpayers, with a great gain in accuracy of returns.

Mechanization.—Much greater use should be made of mechanical equipment and photography in accounting, recording, filing, and indexing in the collectors' offices. This area "probably offers the greatest single opportunity for direct and indirect savings in the operation of the Bureau." (p. 38)

Bureau Returns.—About 5 per cent of income tax returns are now classified as Bureau returns and sent to Washington for processing and in some cases returned to the field for investigation. All the work now done in Washington,

except tabulation of statistical data, should be done in the field. Returns should be loaned to the Statistical Division for tabulation.

Interest. — Interest computations should be simplified by adoption of a single interest statute uniformly applicable to all taxes. Interest on refunds and assessments might begin six months after due date for the return, payment, or refund or credit. Penalty interest should be applied in cases where payments were not made when due.

Offers in Compromise.—Collectors or supervisors of accounts and collection should have limited authority to approve offers in compromise, which must now be approved by the Secretary of the Treasury.

Post Review.—Post review of field settlements by the Audit Review Division of the Income Tax Unit should be made on the basis of a scientific sample of all field settlements to assure uniformity and high enforcement standards. Settlements reached in the field, however, should not be disturbed; the audit would be for management purposes only.

Large Refunds.—Refunds in excess of $75,000 may not be made until thirty days after submission of a summary of the facts of the case to the Joint Committee on Internal Revenue Taxation. These summaries are prepared, and the cases reviewed, by the Office of the Chief Counsel, and in the process issues of fact as well as of law are reopened. The Joint Committee staff in turn reviews the cases. It is doubtful that the cost and delay involved in the existing procedure are warranted. The statutory requirement for submission of refunds to the Joint Committee should be repealed.

Closing Agreements.—The present requirement that closing agreements between the Commissioner and taxpayers be approved by the Secretary, Under Secretary, or Assistant Secretary of the Treasury should be eliminated.

Substitution of Meters for Stamps.—Substitution of metering devices for the stamps now used in administration of thirteen classes of taxes would bring about greater economy and efficiency.

Personnel.—The Bureau's technical training program for employees is comprehensive and well planned. The only change suggested is a shift of emphasis from "production" (assessment of deficiencies) to proper determination of tax liabilities.

Timing of Income.—Problems of timing of income have resulted in much unproductive litigation and have added to administrative costs. Almost 10 per cent of protested cases pending in agents' offices involve depreciation. Such disputes could be reduced, with a saving in administrative costs and in expense to taxpayers, by allowance of more flexibility in timing of depreciation allowances. There is merit in a proposal by the American Institute of Accountants that the Bureau, after consultation with industry groups, publish a list of depreciation rates approved for a wide variety of assets and that taxpayers be allowed 25 per cent leeway from these rates.

Amendments to the Code.—The Commissioner should be required by law to bring periodically to the attention of the Joint Committee on Internal Revenue Taxation sections of the Internal Revenue Code that, in his opinion, require amendment to facilitate administration. These reports should be submitted as necessary but at least

as often as the beginning of each session of Congress.

TREASURY AND BUREAU STATEMENTS

Prior to its public release, the report of the advisory group was referred by the Joint Committee to the Treasury Department and the Bureau of Internal Revenue. Their reactions are set out in statements by Under Secretary A. L. M. Wiggins and Commissioner George J. Schoeneman, which were published by the Committee at the same time as the report.

Treasury Statement

Under Secretary Wiggins concurred with the advisory group that present enforcement activities are inadequate and pointed to Treasury requests for larger appropriations. He stated that the Treasury believes that the estimates made in the report were realistic appraisals of manpower and money needed but suggested that it might not be possible to recruit and train all necessary additional personnel during one year. He said that additional appropriations, if obtained, would be applied in part to secure additional mechanical equipment. He also concurred in the suggestion for a staff agency for the Commissioner and suggested a chief staff officer, with civil service status, who would be equal in rank with the two assistant commissioners.

The Under Secretary disagreed with the recommendation that the Chief Counsel of the Bureau be made responsible to the Commissioner rather than to the General Counsel of the Treasury. He said that the existing arrangement has worked successfully for fourteen years and that the proposed change would result in a loss of coordination and efficiency. He conceded that certain types of closing agreements do not need to be approved by the Secretary but expressed the opinion that other agreements affect matters of policy and should be reviewed by the Treasury.

Bureau Statement

The Commissioner's statement expressed more or less complete agreement with the following suggestions of the advisory group: development of a staff agency for the Commissioner; simplification and improvement of return forms; increased mechanization; simplification of interest computations; delegation of limited authority to compromise cases to certain field officers; substitution of meters for stamps; training program; and suggestions for revision of the Code. In some of these cases, the agreement was said to be "in principle" with details to be worked out. The Commissioner agreed as to the desirability of additional mechanical equipment and explained that an earlier mechanization program had been nullified because it was impossible to secure equipment during the war.

In the view of the Commissioner, the suggestions for reorganization of the field offices require further study, which, he stated, is now under way. He implied skepticism with respect to the suggestion for consolidation of the Technical Staff with other technical personnel, stressing the desirability of offering taxpayers an opportunity for confidential review of controversies within the Bureau by an independent group such as the Technical Staff. The Commissioner dissented from the advisory group's suggestion with respect to flexibility of depreciation allowances, but pointed out that the Bureau allows

adjustment of estimated useful lives of assets when necessary to reflect a taxpayer's situation. The Commissioner said that the existing arrangement with respect to the position of the Chief Counsel is working satisfactorily from the Bureau's point of view.

An informal check with the Bureau elicited the information that numerous procedural mimeographs are now in various stages of completion looking toward the adoption of as many of the recommendations as are immediately feasible. Among them are a number designed to eliminate routine tasks in the Washington headquarters so as to permit the headquarters to have more time to devote to its three major responsibilities: (1) management; (2) technical rulings of a policy nature; (3) controls designed to insure uniformity of administration. Changes of this nature involve many technical problems in respect to delegation of authority and related interests of offices other than the Bureau, such as the Disbursing Office and the General Accounting Office. These problems are being met with all possible speed and it is anticipated that a more definite report may be available in the near future as to specific accomplishments.

TREASURY COMMITTEE

On July 2, 1948, Secretary of the Treasury Snyder announced[3] the creation of a committee to direct management studies of the Bureau of Internal Revenue. The announced purpose of the special committee is to "coordinate and direct the implementation of proposals contained in recent reports on the Bureau by the Bureau and Treasury Departments staffs and by a staff employed by the Joint Committee on Internal Revenue Taxation, as well as other proposals which will result from management studies within the Bureau itself or which emanate from outside specialists." Under Secretary Wiggins was designated chairman of the committee, and he will continue to serve in that capacity despite the fact he has since resigned as Under Secretary. Other members of the committee are: George Schoeneman, Commissioner of Internal Revenue, vice chairman; T. C. Atkeson, Assistant to the Commissioner; Fred Martin, Assistant Commissioner of Internal Revenue; E. F. Bartelt, Fiscal Assistant Secretary of the Treasury; W. W. Parsons, Administrative Assistant to the Secretary of the Treasury; John L. Fahs, Collector of Internal Revenue, State of Florida; B. W. Wilde, Agent in Charge, Dallas, Texas; C. B. Stauffacher, Assistant Director in Charge of Administrative Management, U.S. Bureau of the Budget; Richard W. Nelson, Office of the Assistant to the Commissioner of Internal Revenue, secretary to the committee.

R. G.

[3] Treasury Department press release No. S-784, July 2, 1948.

THE LOUISIANA PROPERTY TAX RELIEF FUND: A SOURCE OF FINANCIAL ASSISTANCE FOR LOCAL GOVERNMENTS

EDGAR J. DAVIES *

IT IS becoming increasingly evident that the primary source of local government revenue, the general property tax, is no longer adequate to support the multitude of public services which local units are called upon to provide. It is necessary, therefore, either to devise some method of broadening the local tax base or to provide additional state aids for local governments. Raising over-all property tax rates would, in most cases, work an undue hardship on property owners. Some states have permitted an increase in local property tax rates by turning the property tax over to local governments for their exclusive use. Some states have attempted to provide additional tax sources for local units.

In Louisiana the State refunds to local government units revenue lost as a result of homestead tax exemptions. Under the authority of a 1940 constitutional amendment the legislature has dedicated the entire proceeds of the income tax, alcoholic beverage tax, and public utility taxes to a Property Tax Relief Fund for the purpose of making annual payments to local units of government to reimburse them for the amount which they lose in revenue owing to the operation of the homestead tax exemption. Municipal corporations are subject to the provisions of the homestead amendment but do not receive payments from the Relief Fund. The City of New Orleans, however, is treated as a parish government and hence is benefited by the Relief Fund. In 1946 approximately $5,-400,000 was thus returned to local government units.

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This system of reimbursing local units for losses sustained from the exemption of certain property from taxation is a potentially desirable means of providing state aid to local government. One of its main advantages is the fact that the Property Tax Relief Fund offers an immediate source of revenue. There is no long waiting period between the time of the tax levy and the time of collection. A further advantage is that the local governments are relieved of the problem of property tax delinquency. In times of financial stress, availability and certainty of revenue are of paramount importance to local units of government. It is well, therefore, to note in this connection that the sources from which the Relief Fund derives its proceeds have proved more productive than property taxes in slump years. The uncertainty as to the funds available for expenditure in the ensuing fiscal period is thus largely dispelled. As a result of this stability of revenue, the local government is better able to balance outgo with income.

Consideration should also be given to the fact that the taxes dedicated to the Fund are for the most part those which the average unit of local government would find it impracticable to tap through its own tax program. From the administrative standpoint alone it would be difficult indeed for each unit to levy its own income, alcoholic beverage, and public utility taxes. The job of gathering sufficient data for the purpose of valuing public utility property is admittedly beyond the capacities and facilities of most local assessors. Moreover, the disadvantages which would arise from the unequal taxation of alcoholic beverages if entrusted to the individual local units

are manifest. State collection of these taxes and an equitable distribution of the revenue derived from them has much to commend it. It is entirely plausible that such an objective could be accomplished through the use of the Property Tax Relief Fund.

The principal drawback to the system of refunds as it exists in Louisiana at the present time is the discrimination between municipalities and other units of local government. Until municipalities become recipients of a proportional share of the proceeds from the Fund, its full potentialities as an instrument for broadening the tax base of local government cannot be realized.

There are four specific criticisms which can be leveled against the Property Tax Relief Fund as it operates in Louisiana, three of which are directly attributable to the inequality of distribution as mentioned above. The criticisms of the plan are as follows: (1) it encourages poor assessment, to the detriment of the State and municipal governments; (2) it places a premium upon excessive special districting; (3) it causes an unequal distribution of the tax burden over the State; (4) it makes the suffrage requirement of property ownership in special bond and tax elections virtually meaningless.

It is admittedly impossible to achieve perfect assessment of property even under optimum conditions, but assessments in Louisiana fall short of standards that have been achieved elsewhere. The Revenue Code Commission of the Louisiana legislature pointed out in its Preliminary Report of April, 1946, that property taxes are levied and collected upon only about 25 per cent of the true value of all property in the State. This is the case despite a constitutional requirement that all property, not specifically exempted, shall bear its just portion of the tax burden and shall be assessed at its actual value. This undervaluation may be attributed in part to a natural tendency of the parish assessor to favor his constituents. The assessor is inclined to endeavor to bring his assessment figures into close proximity with the maximum homestead exemption ($2,000) so as to get the largest share of the proceeds from the Fund possible for his jurisdiction. He tends to raise the value of the property that is worth less than $2,000 and to lower the value of that which is worth more. In this fashion the assessor is granting double relief to the taxpayer whose property is worth more than $2,000; and in the case of the property of lesser value, he is, without placing any burden upon the owner, raiding the State treasury by increasing the local share in the Property Tax Relief Fund.

Since the parish assessments are also the basis for municipal levies, the municipal government loses a large portion of its tax base when the assessments are lowered by the parish assessor, which seems to be the more common practice. This is a financial loss for which the municipality is not reimbursed from the Property Tax Relief Fund as are the other units of government.

Promiscuous special districting has been encouraged because of the procedure followed in the distribution of the proceeds from the Fund. In a municipality, governmental services must be supported by city taxes, but, in a nonincorporated area which relies upon special districts to provide local services, the home owner is able to shift the largest share of the cost of local services to the State (and thus indirectly to the city dweller who purchases alcoholic beverages, tobacco, and electric power). The effect is to discourage an integrated system of local government.

The distribution of the tax burden throughout the State is decidedly unequal because of differences in the quality of assessments and because of the practice of creating special districts. The result is that inhabitants of one area are called upon to aid in supporting the governmental services of another area without receiving any

measure of support for similar services of their own.

With regard to the suffrage requirements for special bond and tax elections, the Constitution stipulates that only property owners shall have the voting privilege. The provision was designed to hold unnecessary expenditures to a minimum, for few property owners would heedlessly vote to increase the levy against their holdings. However, owing to the operation of the homestead exemption, many property owners in the areas outside municipalities pay little, if any, property taxes. Nevertheless, these property owners have the right to vote in the special elections and do so. When they vote they are apt to be uninhibited by any considerations of what the project in question will cost, for they know that any deficit incurred will not be met from additional taxes levied against their property, but instead will be met from the Property Tax Relief Fund.

The evils of the Louisiana version of the Property Tax Relief Fund are not inherent in the system. They can be reduced by making the Relief Fund applicable to all local government units, including municipalities. Moreover, the State Tax Commission could apply more vigorously its authority to exercise supervisory control over assessment. If any qualifications for voting in special bond and tax elections are to be retained they could more logically be based upon taxpaying rather than property holding. The Property Tax Relief Fund might then become a real contribution to harassed local government and a welcome source of relief to property holders.

FEDERAL-STATE FISCAL RELATIONS

AN IMPORTANT development in Federal-state fiscal relations during the past twelve months has been the work of a joint conference of representatives of the Congress of the United States and the Governors' Conference. The purpose of the meetings of this joint conference, which was initiated by the Governors' Conference, has been to develop a coordinated Federal-state fiscal program. Meetings were held in September, 1947, at Chicago; in January, 1948, at Washington; and in August, 1948, at Chicago. Resolutions were passed at both Chicago meetings, while the Washington meeting heard reports of progress. Meanwhile some action along the lines of the resolutions has taken place in Congress, and the Governors' Conference has endorsed the work of the joint conference and called for its continuance.

At the meetings the Governors' Conference has been represented by its Special Committee on Federal-State Tax Relations. The Congress has been represented by members of the Ways and Means Committee and the Committee on Expenditures in the Executive Departments of the House of Representatives, and by members of the Senate Finance Committee and the Senate Committee on Expenditures in the Executive Departments. Thus far the joint conference has not included representatives of the Congressional appropriation committees, of Federal executive departments, or of state legislatures.

The first Chicago meeting was attended by Governors of fifteen states, ten Representatives, and six Senators. After two days of deliberation, the members of the conference unanimously adopted a joint statement embodying general principles and an immediate objective. The conference issued the following statement of general policy:

"To achieve a higher degree of efficiency, reduce duplication, and achieve economy and stability in our coordinated system of Federal, State, and local governments, our States must cease relying upon the Federal Government to do those things which they can do for themselves as well as, or better than, the Federal Government. In order that the State and local governments may be enabled to assume those functions, the Federal Government should reduce those taxes which can be administered best by State and local governments.

"As a program for immediate action, the conference agreed:

1. That the Federal Government should reduce Federal excise taxes as soon as practicable (special consideration should be given to local telephone calls, intrastate electric energy, gasoline and admissions taxes);

2. That the Federal Government should amend inheritance and estate taxes to provide more equitable division of this revenue between the Federal Government and the States;

3. That the Federal Government should relinquish to the States the Federal tax on employers levied to cover the administrative expenses of the State employment-security programs, and the States will assume the responsibility for the administration of the unemployment-compensation and employment-service programs;

4. That the Congress take the earliest possible action to correct by Federal law the income-tax inequities existing between the community-property and the non-community property States;

5. That the States should avoid encroachment upon tax fields which are peculiarly adaptable to Federal uses."

An outgrowth of the Chicago conference was the issuance of a report on the "Coordination of Federal and State Taxes" by the Senate Committee on Expenditures in the Executive Departments. In this report the Committee endorsed the recommendations of the Chicago conference. It also recommended that the Joint Congressional Committee on the Legislative Budget, as a regular procedure, confer with and afford hearings to representatives of the states prior to reporting to Congress its recommendation for the maximum amount to be appropriated for Federal expenditures in

each year. A bill was introduced into Congress to carry into effect the recommendation of the Chicago conference regarding administrative expenses of state employment-security programs, but was not acted on. The Revenue Act of 1948 removed the income tax differentiation in favor of community-property states; however, although the act substantially reduced expected revenues, it did nothing to reduce Federal excise taxes or to change the division of inheritance and estate tax revenues between the Federal Government and the states.

The Governors' Conference, at its annual meeting in June, 1948, unanimously adopted the following resolution relating to Federal-state fiscal relations:

> "To achieve a higher degree of efficiency, reduce duplication, and achieve economy and stability of our coordinated system of federal, state, and local governments, our states and their citizens must cease relying upon the federal government to perform services for them that they could do for themselves as well as, or better than, the federal government. In order that the state and local governments may be able to assume those functions, the federal government should withdraw from or reduce those taxes which can be best administered by state and local governments.
>
> "The Governors' Conference will support federal-state programs designed to coordinate federal-state services and fiscal structures, and eliminate any over-lapping and wasteful duplication that may exist therein. We believe we should seek to develop:
>
> 1. Adequate standards of service responsibility to the end that governmental services may be allocated to that level of government which can most effectively recognize and meet local needs;
> 2. Adjustments in our tax structures designed to assure a fair and equal application of existing taxes to all taxpayers, as well as a fair apportionment of the total tax burden among all those who either pay or should be paying a share of the cost of government."

In its resolution the Governors' Conference also approved the work of its Special Committee on Tax and Fiscal Policy in conferring with representatives of the Congress, and continued the Committee, directing it "to further develop proposals for tax coordination between the Federal and state governments in cooperation with appropriate Federal authorities." The resolution also requested the Congressional committees to continue "to work in cooperation with the Governors' Conference toward coordination of policy and administration in the twin problems of Federal and state services and tax structures."

After its latest meeting at Chicago the joint conference, on August 25, 1948, issued a statement which followed the general principles of the previous year's resolution, but differed in emphasis by including a recommendation for a reduction in Federal grants-in-aid to the states. This proposal is made in a sentence which also calls for Federal withdrawal in whole or part from certain tax fields. The following passages are from the statement:

> ". . . the federal government should reduce those taxes which can be administered best by state and local governments. To implement this policy, the joint conference recommended:
>
> 1. "That grants-in-aid from the federal government to the states for continuing activities be reduced by not less than 20 per cent for the fiscal year 1950 and that the federal government withdraw from or reduce rates in connection with certain tax fields that can best be used by state and local governments. . . .
> 2. "That the technical staffs of the appropriate committees of the two Houses of the Congress and of the Governors' Conference be directed to develop a concrete plan in accordance with this over-all policy, such a plan to be submitted to the appropriate committees of the two Houses of the Congress and to the Governors' Conference.
> 3. "It is further proposed that very soon after the convening of the 81st Congress, the appropriate committees of the two Houses arrange a joint meeting with the Tax Committee of the Governors' Conference to discuss the general policy and the proposed plan."

The statement also pointed out that states and localities "are strenuously searching for additional sources of revenue" and that "if and when the federal government withdraws from or makes reduction in certain areas of taxation, these fields of taxation will be available to the states and local governments for such use as they may determine."

R. B.

BRITISH ANTI-INFLATIONARY TAX ON DISTRIBUTED CORPORATE PROFITS

MORRIS BECK *

IN APRIL, 1947, Great Britain revised its tax on corporate profits in an attempt to discourage distribution of earnings. At that time corporations were paying income tax at a standard rate of 45 per cent and a profits tax at the rate of 5 per cent. Chancellor of the Exchequer Hugh Dalton called for a 12.5 per cent rate on distributed profits because "too much has been distributed and too little ploughed back into the business. These increased dividends are the clearest case, anywhere in our national economy, of an inflationary element. They are a case of paying more money for no work at all—and that is very hard to justify, and, in my view, clearly calls for some fiscal correction."[1]

In a supplementary Financial Statement on November 12, 1947, he called for a doubling of the profits tax rates, on these grounds: "I have noticed, with regret, a continuing and persistent inclination on the part of many concerns to declare increased dividends. This is contrary to advice which I have ventured to offer from time to time; it is inflationary, because it puts more purchasing power into circulation; and it is disturbing to industrial relations. Moreover, profits as a whole are still running at a very high level."[2]

The rate on distributed earnings was increased to 25 per cent and on retained earnings, to 10 per cent. Companies which distributed all of their earnings would pay an effective rate of 58.75 per cent.[3]

The 1947 measure to discourage dividend distribution is consistent with a similar step taken in 1946 when the excess-profits tax was repealed. The repeal measure stipulated that postwar refunds must be ploughed back into the business and not dissipated in dividend payments. The profits tax of 1947 is specifically designed to encourage retention of earnings, a policy which is in direct contrast to current American and Canadian tax policy aimed at discouraging excessive corporate accumulation. The principal objective of the British levy, with its discriminatory rate on distributed earnings, is to reduce the pressure of dividend income on the price level; simultaneously, however, the measure is expected to stimulate plant expansion and modernization.

Since government action was predicated on the belief that companies were enlarging their dividend payments, it may be instructive to look at the profit and dividend figures for recent years. Table 1 presents a comparison of dividend payments for 1945-47, based on a sample of 511 companies.

Certainly the absolute amount of dividend payments had increased since the end of the war. Before drawing conclusions, however, it may be wise to see what had happened to the dividend-to-profit ratio and the rate of payment on capital. Table 2 shows estimates by *The Economist* which are believed to rest on a sample which

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[1] *Parliamentary Debates: Commons*, vol. 436, 1946-47, p. 85.

[2] *Ibid.*, vol. 444, no. 17, p. 402.

[3] Profits tax paid is deductible from the income tax base. A corporation earning £100 gross and retaining none of it, pays £25 profits tax and £33.75 income tax on the balance of £75. Total tax is therefore £58.75.

TABLE 1

Dividend Payments of 511 British Companies, 1945-47
(Amounts in Thousands of Pounds)

	1945		1946		1947	
	Amount	Index	Amount	Index	Amount	Index
Preference dividends	9,638	100.0	10,297	106.8	11,240	116.6
Ordinary dividends	29,050	100.0	34,092	117.4	37,349	128.6
Total dividends	38,688	100.0	44,389	114.7	48,589	125.6

Source: Table 1, 511 4th Quarters Companies' Gross Profits, *Records and Statistics,* supplement to *The Economist,* February 14, 1948, p. 147.

covers 40 per cent of industrial profits in Great Britain.

Whereas aggregate dividend payments in 1947 had increased approximately a quarter over 1945, the ratio of dividends to profits had actually declined. Table 2 also tells us that companies were not distributing profits as fast as the profits were being earned; for while the rate of earnings on ordinary capital had risen approximately one-half (from 16.7 per cent to 25.2 per cent), the rate of payment on ordinary capital had risen by less than two-fifths (from 11.2 per cent to 15.5 per cent).

TABLE 2

Distribution of Profits and Returns on Capital, Sample of British Companies, 1945-47

	1945	1946	1947
		(Per Cent)	
Proportion of gross profits:			
Preference dividends	18.8	17.8	14.2
Ordinary dividends	56.5	56.6	52.8
To free reserves	24.7	25.6	33.1
Rate of payment (gross):			
Debenture interest	4.4	4.4	4.2
Preference dividends	6.1	6.3	6.4
Earned on ordinary capital	16.7	18.0	25.2
Paid on ordinary capital .	11.2	12.4	15.5

Source: Table 2, p. 147, *Records and Statistics,* supplement to *The Economist,* February 14, 1948.

Since the alleged purpose of the 1947 profits tax was to mitigate inflationary pressure arising from that segment of the community which receives dividends, it would be worth while determining what portion of the national income goes to dividend recipients. This information is not readily obtainable from the government estimates of national income because these documents do not segregate dividend income from other forms of investment income. Professor Tibor Barna, however, has estimated aggregate dividend payments for 1938-1944 and found that dividends typically constitute less than 10 per cent of home-produced national income.[4] An anti-inflationary program directed at such a limited segment of the economy would, standing by itself, have little chance of success. Certain other considerations cast further doubt on the effectiveness of such a program. A generous proportion of dividends must go to individuals in the middle and upper income brackets whose propensity to save is relatively high. It appears to be an implicit assumption of the Dalton measure that the beneficiaries of the increased dividend payments will spend their additional income on consumer goods.

One of the secondary objectives of the 1947 profits tax was to stimulate corporate investment programs financed out of retained earnings. Agreement is widespread that British industry needs some remechanization and modernization. In the cotton industry, for example, automatic looms

[4] See *Profits During and After the War* (Research Series no. 105, Fabian Publications, Ltd.), Tables 2 and 4, pp. 6 and 8.

for weaving cover no more than 5 per cent of the industry, as compared with 95 per cent in the United States. The question which must be answered, however, is whether a tax policy favoring the retention of corporate earnings will be of positive value to the re-equipment program; for it is believed that the industries which have been examined "have adequate financial resources in their own possession or available to permit the changes suggested."[5] The problem, then, is not one of providing incentives for increased corporate saving, but of persuading British industry to use these accumulations for modernizing its plant and equipment.

It must be recognized, too, that an accelerated investment program may aggravate the inflation which the tax policy was designed to arrest. Initially, at least, the investment program would mean additional pressure on the prices of scarce building materials and the bidding away of labor from other employments. However, as long as the investment results in an expansion of national output, and thus narrows the gap between goods and purchasing power, it has a higher priority than other types of inflationary spending.

The 1947 profits tax is bound to have widespread repercussions on the British economy. Its effectiveness as a counter-inflationary measure depends mainly on whether it is successful in retarding dividend distributions and generating new investment. But we have seen that such a conclusion rests on a questionable assumption concerning the propensity to consume of dividend recipients, and that the short-run effect of uncontrolled investment spending may be a new inflationary pressure. A final decision concerning the impact of the tax on the price level should also take into account the government's disposition of additional revenue produced by the tax.

[5] Machinery and Allied Products Institute (Geo. Terborgh, director of research), *Technological Stagnation in Great Britain* (January, 1948), p. 58.

BOOK REVIEWS

Historical Review of State and Local Government Finances. U.S. Department of Commerce, Bureau of the Census, Governments Division. (State and Local Government Special Studies No. 25.) Washington, June, 1948. Pp. 42, including 13 charts and 24 tables.

Adolph Wagner (1835-1917) would not have been surprised to see the evidence for his familiar " law of increasing state activities " which has been conveniently assembled in this recent Census Bureau report. Several of the tables and charts in the report cover the period 1890-1946, during which state and local revenue has multiplied about twenty times in absolute amount and more than tenfold per capita.

Only small segments of the public, perhaps, are more than vaguely aware of the magnitude and trends of state and local government finances during recent decades. Even to those closely concerned with fiscal affairs this all-too-limited compilation of Census data will have excellent reference value and may offer some surprises. Who would have supposed, for example, in the absence of figures here provided, that the proportion of state and local operation expenditure devoted to streets and highways was lower in 1942 than thirty, forty, or fifty years earlier? Who would have imagined that, in the inflated postwar year of 1946, state and local property tax revenue was less, per capita, than in 1932?

Most of the information here assembled, of course, is not " news," having been drawn together principally from previous annual and decennial reports of the Bureau of the Census. Nevertheless, the report will be widely welcomed, as a useful complement to current Census reports on government finances. Lacking such a collection of historical and background data, the scholar or researcher has usually had to refer to numerous separate Census reports, and has encountered problems of varied arrangement of data and, far more serious, of shifts in concepts, definitions, and content of figures in the various sequential reports. It was this situation which led a special committee of the research section of the National Association of Tax Administrators to place high priority upon the preparation of a historical report of this general nature, in making recommendations to the Census Bureau last year.

As is pointed out in the introduction to the Census publication:

> Census data on governmental finances have been closely comparable within—but not between—three historical periods: pre-1937, 1937 to 1940, and 1941 and subsequent fiscal years. The aim of the report has been to link these three periods in such a manner as to provide the maximum possible amount of comparable historical information for the entire period. (p. 1)

Unfortunately, the " maximum possible " referred to is below the potential scale which compilation, recasting, and readjustment of all usable Census data of recent decades would have permitted. As stated elsewhere in the report, " there exists in these [earlier regular Census] records and reports a wealth of other valuable statistics that could not be developed within the . . . limits. . . ." of this special study. Thus, only five of the twenty-four tables in this publication provide state-by-state data, and many users of the figures will wish that more extensive figures of this type had been brought together.

However, an excellent summary of major historical developments in Census classifications for reporting on governmental finances, and detailed footnotes to the several tables, should enable the competent student to apply appropriate techniques in developing comparative data for particular segments of data found in earlier Census publications.

A more serious deficiency in this report reflects problems beyond the control of the Governments Division of the Census Bureau, i.e., the serious gaps in important data which result from the inadequate scale of Federal statistical work in this field during various past periods and even at the present time. To mention only two examples: (1) Drastic reduction in support for this field of activity in the early 'thirties led to complete cessation of annual reporting on state government finances for the fiscal years 1933 to 1936—a period when the states were undergoing very drastic fiscal changes; the result is a complete gap in reliable over-all state finance data for those dynamic years; (2) in the absence of figures for small cities, townships, school districts, and special districts, data on total local government expenditure (and therefore state-local and Federal - state - local totals) are not available for any year more recent than 1942, when the latest decennial Census of Governments was undertaken. It is surely high time that this serious gap in current knowledge on government finances be filled, so that annual totals on public expenditure—in addition to those on revenue and debt—would be available from the Census Bureau.

One might also wish that this special report had been broadened to include Federal Government data. No doubt limits of staff and money resources were controlling on this score also.

These limits on the scope of the special study are unfortunate, but by no means fatal. They will not prevent its wide use by persons engaged in fiscal and economic research, governmental planning, and the teaching of economics and political science. In particular, it may be noted that what struck many scholars as a serious technical defect in 1942 Census of Government reports—a failure to "net out" duplicating fiscal aid transactions from state-local aggregates—has here been corrected. The same improvement has been made in a companion special study issued concurrently by the Census Bureau—*A Revised Summary of State and Local Government Finances in 1942.*

Altogether, the user of these reports is likely to feel, as he often does in using other recurrent Census publications on governmental finances and employment, that they are excellent as far as they go, but that more extensive information would be highly desirable.

Wm. G. Herzel

Federation of Tax Administrators
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Concerning a New Federal Financial Statement. By Morris A. Copeland. New York: National Bureau of Economic Research (its Technical Paper No. 5), December, 1947. Pp. 63. $1.00.

No one form of financial statement can be expected to serve all purposes. Some statements are primarily for management purposes, some for accountability, some for economic analyses, and some for other needs. The principal financial statements of the Federal Government—the Daily Treasury Statement, the Budget, the monthly Bulletin of the Treasury, and the principal tables in the Annual Report of the Secretary of the Treasury—give an accounting to the public of funds in the Treasury and of checking accounts and special deposits which certain Government corporations and enterprises have established with the Treasurer of the United States.

While the principal existing statements probably serve their purposes reasonably well, they have certain important drawbacks, especially for the economist. They net certain transactions, particularly the Post Office and Government corporation checking accounts, where he wants gross figures. They use gross figures, particularly for inter-fund transactions within the Treasury, where he would prefer net figures on transactions with the public. They omit entirely those Government transactions which do not pass through the Treasury or

the Treasurer's accounts, such as the receipts and expenditures of the Panama Railroad Company. They do not itemize expenditures by character or object of payment. They show cash balances, but not the balance of Government loans outstanding.

The author presents in this paper his proposal for a new form of Federal financial statement which he believes will overcome these specific difficulties, and hence facilitate the task of observing the impact of Federal financing on business conditions. The statement is conceived as one in a set of statements on monetary flow, for purposes of economic analysis. Dr. Copeland illustrates his proposed financial statement with annual figures for the calendar years 1936 through 1942, and appends a series of detailed worksheets showing how he derived figures for the year 1939 from a great variety of published sources. The compilation alone was evidently a laborious piece of work.

Dr. Copeland further suggests that his figures should be brought down to date, that such statements be issued on a quarterly basis currently, and that they be projected into the future in line with budgetary estimates.

In theory, the use of the gross basis for corporations and the Post Office is desirable in tracing the monetary flow, although it might not be right for certain other economic analyses. The gross figures " blow up " the Government sector of the economy, and could distort a clear understanding of the impact of fiscal operations on business conditions; a large part of the transactions of the corporations and the Post Office are determined by private, not public, decisions. The author's decision to exclude loans from expenditures should also be given critical review, considering that certain Federal loans turn out to be subsidies, and even some of those which are repaid represent a Governmental outlay for a public purpose. It is interesting to note that this paper continues the Governmental practice of treating tax refunds as an expenditure, rather than as a deduction from receipts; in this respect it departs noticeably from the usual practice of business financial statements, which it tries to emulate otherwise.

In practice, it would be difficult indeed to compile such statements from a variety of sources without the possibility of error. Inspection indicates that there may be some duplication of figures, particularly between the data on " Miscellaneous Federal Funds " and the data on the " Federal Government General Fund." The task would probably have been easier and perhaps more accurate if the author had obtained more information from Government records and files, instead of relying almost exclusively upon public sources.

This paper clearly indicates the need for additional financial statements to supplement the traditional Treasury statements of receipts, expenditures, and balances. The monthly Treasury Bulletin, the Budget, the Economic Reports of the President, and even more recently the monthly pamphlet *Economic Indicators* (prepared by the Council of Economic Advisers and published by the Joint Committee on the Economic Report) now contain information (not available in published form a few years ago) which would be helpful in analyzing the monetary flow between the Federal Government and the public, and the effect of the Government's budget on the nation's budget.

In January, 1948, the General Accounting Office, the Treasury, and the Bureau of the Budget initiated their first joint program to determine what kinds of financial information the accounts of the Government should produce and how the data should be presented to meet the needs of those who receive the reports. Dr. Copeland's suggestions will no doubt be stimulating and helpful to this project.

Carl W. Tiller

U.S. Bureau of the Budget

Public Finance. By URSULA K. HICKS. (A Cambridge Economic Handbook.) London and Cambridge: Nisbet and Cambridge University Press, 1947. (Distributed in the United States by Pitman, New York.) Pp. xx + 392. $2.25.

The twenty chapters of this relatively short textbook in government finance are grouped under three headings. "Part I—The Public Accounts" (pp. 1-114) opens with a chapter that compares the public sector and the private sector of the economy and distinguishes the various ways in which the public sector is financed. The changing character of public expenditures in Great Britain since the days of Adam Smith is discussed in the second chapter. The four remaining chapters of the section describe British public finance methods including the procedures of appropriation and control of expenditures, the sources of revenue, and the budget accounts and their interpretation. Brief references are made to American practice.

The theoretical heart of the book is in "Part II—The Theory of Taxation" (pp. 115-315). The opening chapter on "The Art of Public Finance" presents the production optimum and the utility optimum as the principal criteria for public finance policy. The next chapter traces from the sixteenth century to the present time the evolution of the ideals of tax justice which have been followed in British tax legislation. "Formal incidence" (which corresponds to "incidence" as the term is used in most public finance writing) and "effective incidence" (approximately what is referred to in other works as "economic effects") are distinguished. Various types of tax classifications are examined. The most useful ones for tax analysis are found to be the distinction of taxes on outlay from taxes on income and the distinction of partial taxes from general taxes. Different kinds of taxes are then analyzed with respect to formal incidence and effective incidence; chapters are devoted to partial outlay taxes, outlay taxes on capital goods, taxes on net income and profits, capital levies and capital taxes, and other taxes. These are very illuminating chapters. The financial problem of federalism and local government is then discussed with special reference to Britain, and desirable solutions are indicated. The last chapter of Part II examines the distribution of the tax burden and presents estimates of the distribution effects of taxation and public expenditures in Great Britain.

"Part III—Public Finance in the National Economy" deals with what in the United States is usually referred to as "fiscal policy," that is, with the relation of public finance to the level of business. The opening chapter presents the theory and describes revenue and expenditure techniques. The next chapter discusses the process and problems of planning public investment, with particular reference to Britain. A chapter follows on the problems of borrowing and debt management ("loan policy and public debt"). The final chapter of the book reverts to the budget process and the public accounts and makes recommendations for their improvement in Great Britain.

This book will be a useful one to students and other readers in the United States. The description of British financial institutions throws light both on the British situation and also by contrast on the adequacy of public finance procedures in the United States. The theoretical material appearing in section II is to a considerable extent an original approach to tax theory not available in other textbooks. The fiscal policy material is not particularly original but is just beginning to appear in textbooks published in the United States. The important developments of fiscal theory and practice of the past generation have been incorporated in this book; indeed they dominate the organization of the work.

The book is written throughout in an interesting and scholarly style without waste of words. The treatment in many

chapters is broad rather than detailed, the result of covering a large field in a relatively short work. The brevity and general sweep of the treatment are suggestive of what might be done but has not often been done in public finance books published in this country.

Mrs. Hicks' book is not likely to replace either of two older British books, Dalton, *Principles of Public Finance,* and Pigou, *A Study in Public Finance.* In some respects it appears to have been written with the existence of these books in mind. Perhaps for that reason it does not present a detailed examination of certain traditional fiscal principles. Aside from five chapters (IX-XIV) which are purely theoretical, the treatment for the most part combines theoretical materials and historical or institutional materials. The result is a practical and realistic approach to the problems of public finance policy.

Since the financial institutions and problems in the United States differ substantially from those of Great Britain, this book cannot be expected to substitute for domestic textbooks in public finance. Furthermore the brevity of the book will require that some of its theoretical sections be supplemented by the more usual analyses. This reviewer looks on the book as a supplementary text which gives a comprehensive modern view of the subject in not overly-long form, facilitates comparison between the United States and Great Britain, and adds theoretical material not otherwise available. The book is a valuable addition to financial literature.

R. B.

Taxation of Public Service Corporations in Virginia. Report of the [Virginia] Public Service Tax Study Committee, to which is appended the research Report to the Committee by James W. Martin, Research Director and Consultant. Richmond: Commonwealth of Virginia, 1947. Pp. xxvi + 152.

The Virginia Public Service Tax Study Committee was created by a resolution of the State House of Delegates in 1946. It was directed to examine: (1) the existing system of assessment of the property of public service corporations; (2) the equity of the existing gross receipts tax on railroad companies, as compared with the taxation of these companies in other states in which they operate; (3) what changes, if any, should be made in the Virginia system of assessment and taxation. The report of the Committee occupies the first 17 pages of the present volume, that of the research director, the remaining 161 pages.

The Committee concludes that the Virginia gross receipts tax does not impose an excessive tax load on railroads as compared with taxes in other states and recommends continuation of the Virginia tax. It opposes the adoption of the unit method of valuation of utility property.

The research report examines the method of assessing public service corporation property in Virginia; outlines the unit method of valuation, which is not used in Virginia; discusses allocation, apportionment, and equalization problems; and presents a statistical comparison of taxation of railroads in Virginia and in other states in which these roads operate.

State and Municipal Tax Systems of the 25 Largest Cities of the United States and the 18 States of Which They Are Part, Including the State of Ohio and the City of Cincinnati. By CINCINNATI BUREAU OF GOVERNMENTAL RESEARCH. (Report No. 98.) Cincinnati, 1947. Pp. ii + 66 + 44 tables (mimeographed). $2.00.

This report is part of a study to determine possible sources of additional revenue for the City of Cincinnati. For each major tax, it presents a brief description, information on the extent of its use by the large cities and by states, and data on recent yields. The advantages and disadvantages of the most important taxes are briefly summarized. In addition to the usual

sources of local revenues, the report recommends returning a definite portion of state income tax collections to local governments or supplementing a state income tax with a rate for local purposes (varying among counties but uniform within any one county). These alternatives are considered preferable to additional subsidies, sales taxes, or municipal income taxes of the type used in Philadelphia and Toledo.

The tables present extensive statistical data and tabular summaries of tax provisions, in most instances for the year 1944 or 1945.

Tax Systems. 11th ed. (A Yearbook of Legislative and Statistical Information Including All the States of the United States and Certain Foreign Data.) By Commerce Clearing House, Tax Research Department. Chicago: Commerce Clearing House, Inc., 1948. Pp. vi + 382. $15.00.

The current edition of this "atlas" brings up to date a volume that has come to be regarded as a virtually indispensable aid to those interested in comparative tax systems. As in the past, the volume is divided into four parts: (1) domestic tax charts, including a summary chart of the tax system of the United States, of each of of the forty-eight states, and of Alaska and the District of Columbia; (2) comparative tax tables for the forty-eight states, which tabulate the principal features of each of thirty-three individual state taxes; (3) Federal, state, territorial, and local tax collections in the United States, which includes summary tables, tables for individual states and territories, and tables of collections by sources; (4) foreign tax systems, which includes individual summaries of the tax systems of seventeen countries and in addition tables on some of the subdivisions of members of the British Commonwealth.

The uniform numbering system begun in the ninth edition is continued and should increase the convenience of using the volume. The comparative tables include new tables on homestead and veterans' property, exemptions, racing and pari-mutuel betting taxes, and life insurance premium taxes.

Census Bureau Publications on Governments. U.S. Department of Commerce, Bureau of the Census, Governments Division. Washington, August, 1948. Pp. 2.

This leaflet describes briefly each of the eighteen reports on governmental finances and employment which the Census Bureau expects to issue in the fiscal year beginning July 1, 1948, and lists other recent publications of the Bureau regarding state and local governments. It is available from the agency upon request.

CORRECTION

In the article, "Depreciation in the Tax Laws and Practice of the United States, Australia, Canada, Great Britain, New Zealand, and South Africa," in the June issue of the *National Tax Journal*, the following bibliographic note appeared on p. 174: "*Canadian Tax Service* (Chicago: Commerce Clearing House). (This looseleaf service has been discontinued.)"

The quotation conveys an erroneous impression. The same service has been continued under the title *Canadian Tax Reports*. It is now published by CCH Canadian Limited (Toronto), the subsidiary of Commerce Clearing House, Inc. (New York, Chicago, Washington).

NTA NOTES

ANNUAL CONFERENCE

THE FORTY-FIRST Annual Conference on Taxation will be held in Denver, Colorado, October 3-7, 1948. The Conference will open with registration and a reception Sunday afternoon, October 3. The regular Conference sessions are scheduled for Monday through Thursday, October 4 through 7. Headquarters for the Conference, and all sessions except a Monday luncheon, will be at the Cosmopolitan Hotel.

Hotel reservations should be made with Mr. Clarence N. Hockom, Manager of the Denver Convention and Visitors Bureau, Inc., 519 Seventeenth Street, Denver 2, Colorado. Hotel rates were listed in the June issue of the *Journal*. For single rooms, they range from $2.75 to $8.00 per day; for double rooms, from $2.75 to $11.00 per day; for suites, from $15.00 to $42.00 per day.

The main theme of the Conference will be tax administration and related problems of tax compliance, but several other topics will be discussed. Evening sessions will be held only on Monday and Tuesday. A barbecue on Wednesday evening will take the place of the usual Conference dinner. Extensive arrangements have been made for the entertainment of persons attending the Conference.

The annual business meeting of the National Tax Association will be held on October 7.

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